FEBRUARY 1960

The Controller

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HOW AN ELECTRONICS MANUFACTURER SHARPENED COST RESPONSIBILITIES

Thomas S. Dudick

THE MANAGER LOOKS AT PROFITABILITY MEASUREMENTS

W. Bernard Thulin

ISSUES AT THE HEART OF THE 1961 FEDERAL BUDGET

John A. Beckett

THE ACCOUNTANT'S INTERPRETIVE JOB HOW FAR SHOULD IT GO?

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CONCEPT OF MODERN CONTROLLERSHIP
of Controllers Institute of America

1. To establish, coordinate and administer, as an integral part of management, an adequate plan for the control of operations. Such a plan would provide, to the extent required in the business, profit planning, programs for capital investing and for financing, sales forecasts, expense budgets and cost standards, together with the necessary procedures to effectuate the plan.

2. To compare performance with operating plans and standards, and to report and interpret the results of operations to all levels of management and to the owners of the business. This function includes the formulation and administration of accounting policy and the compilation of statistical records and special reports as required.

3. To consult with all segments of management responsible for policy or action concerning any phase of the operation of the business as it relates to the attainment of objectives and the effectiveness of policies, organization structure and procedures.

4. To administer tax policies and procedures.

5. To supervise or coordinate the preparation of reports to governmental agencies.

6. To assure fiscal protection for the assets of the business through adequate internal control and proper insurance coverage.

7. To continuously appraise economic and social forces, and government influences, and interpret their effect upon the business.

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Correspondence

EDUCATION OF A PRESIDENT

Editors, THE CONTROLLER:

To the controller whose company president wants to educate himself in controllership, finance and accounting (THE CONTROLLER, December 1959, page 555) I would make the following suggestions:

If your president is willing and has the time to take a course of study, I would recommend his participation in the American Management Association's five-day Orientation Seminar on Fundamentals of Finance and Accounting for Nonfinancial Executives. This is designed for management executives and is given every few months in New York and other major cities.

If he is in the New York area and can attend evening sessions at New York University Graduate School of Business Administration, there are some excellent courses in Corporate Finance which are not too technical. One of the best is Financial Administration given by Dr. Jules I. Bogen (editor of the *Financial Handbook* and *New York Journal of Commerce*). Other universities can also offer valuable graduate courses of this nature.

As reading materials, I would recommend:

Financial Handbook (Third edition—1952) edited by Dr. Jules I. Bogen, Ronald Press

Accountants Handbook (Fourth edition—1957), Ronald Press

Practical Financial Statement Analysis (1957 edition), R. A. Foulke (vice president, Dun & Bradstreet)

Management Accounting for Profit Control by I. Wayne Keller (McGraw-Hill—1957)

Budgeting: Profit Planning and Financial Control by Glenn A. Welsch (Prentice-Hall—1957)

General articles on financial management found in THE CONTROLLER* and *Harvard Business Review.*

If I were the controller of his company, I would also consider it my responsibility to provide him with control tools which would enable him to measure his own effectiveness in the areas which are his responsibility, such as net sales, net profit before and after taxes, return on investment, return on net worth, earnings per share, and stockholder's equity per share. I would also give him similar measures of the effectiveness of each of the officers reporting to him, each designed to reflect the functions which are the particular man's responsibility or which are controllable by him.

Each control report would be expressed in simple, explicit and unambiguous terms, without extraneous detail. It would include sufficient historical data to provide a frame of reference or trend; the current position, both actual and compared with budget; and the forecast for the immediate and more remote future.

Each report would highlight variances calling for corrective action, and would be presented promptly enough after the close of the period for such action to be truly effective. I would submit the key factors also in graphic form.

I would also provide him with analyses designed to assist him in establishing departmental performance goals and prices, based on break-even analysis of fixed and variable cost factors.

With these controls in his hands, your president should feel confident that the financial administration of his company is in good hands and that he can safely take the time to orient himself in financial techniques.

DONALD M. CRAWFORD
Manager
Management Controls Division
Barrington Associates, Inc.
New York

THE ANNUAL CON vs. COMP

Editors, THE CONTROLLER:

Several times a year I am asked *"What is the difference between a comptroller and a controller?"*

You and I know there isn't any, but I know I can answer that type of question much more readily if I could recall the excellent explanation of the two words published in THE CONTROLLER several years ago. If you have a reprint or copy of it, I would certainly appreciate it. I wonder, too, if it wouldn't be edifying to our members if this statement in THE CONTROLLER were published again.

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DOCTORAL DISSERTATION

Editors, THE CONTROLLER:

I am engaged in preparing a doctoral dissertation at the Graduate School of Business, Stanford University, California, on the subject of disclosure on financial statements.

As is the custom in many such dissertations, I should like to provide supportive or illustrative materials for some of the contentions I seek to advance.

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(Continued on page 50)

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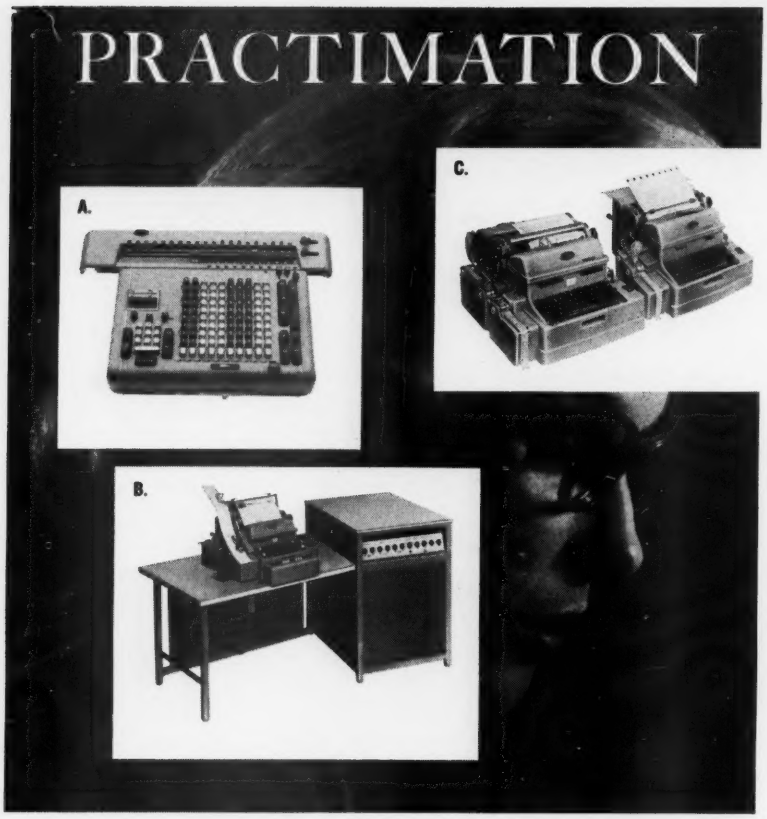

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DELBERT E. WILLIAMSON
La Mesa, California

FINANCIAL MANAGEMENT

Editors, THE CONTROLLER:

In the August 1957 issue of THE CONTROLLER there appeared an article by Louis O. Foster entitled "Rates of Return: The Effects of Borrowing." We would like to use this article as an assignment in our course in Financial Principles. May we have your permission to reproduce this article and place 20 copies in our library where it will be available to our students?

VIRGIL M. BETT
Assistant Professor of Finance
University of Michigan
Ann Arbor, Mich.

•

Editors, THE CONTROLLER:

I should like very much to have permission to mimeograph the article by Professor J. F. Weston entitled "Financial Implications of Growth" which appeared in the March 1958 issue of THE CONTROLLER for use in a seminar in advanced management and in my classes—giving, of course, proper credit to the source.

I am sure this article will prove extremely useful to the advanced seminar.

ELI SCHWARTZ
Associate Professor of Finance
Lehigh University
Bethlehem, Pa.

LITTLE BOUQUETS . . .

Your publication, THE CONTROLLER, to which I have subscribed for some time has proved to be an outstanding publication.—RJC

". . . and, incidentally, may I say that, as a subscriber to your journal, I find it most useful."—Prof. PVR

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HOW AN ELECTRONICS MANUFACTURER SHARPENED

Cost Responsibilities

A budget application to implement forecasting and control of sales and manufacturing costs as put into effect by Allen B. DuMont Laboratories, Inc.

Thomas S. Dudick

INTRODUCTION

When Allen B. DuMont Laboratories reached its peak of growth in 1954-55, it found, as many other companies did in the post-war period, that it had expanded beyond its ability to finance its varied activities. The company spun off its two major telecasting stations and discontinued network operations. Both these activities had contributed to sizable deficits.

Concurrently, a finance-oriented president and a new controller were brought into the picture. The controller, realizing that a policy of retrenchment and close controls must be substituted for a policy of expansion and spending, took a critical look at the conventional forms in which budgetary controls and profit-and-loss statements were being used. He found that the close intermingling of costs for an entire product division made it difficult for either the sales manager or manufacturing manager willingly to accept responsibility for the financial results. In the event of a poor showing, each could blame the other and neither could be pinned down.

The paper which follows describes how the company was reorganized in order to pinpoint responsibility and control more clearly, how the profit-and-loss statement was altered to reflect the new organization, and how budgets were established for use in forecasting and control.

* * *

PRIOR TO 1957 Allen B. DuMont Laboratories, Inc., was, like many companies in the electronics industry, organized on an autonomous divisional basis. This meant that the vice president in charge of each division was responsible for all manufacturing, sales, and engineering within it. Under this arrangement, DuMont had the following basic product divisions: TV Picture Tube Division; Industrial Tube Division; Government Division; Technical Products Division; and TV Receiver Division (which has since been sold).

MAPPING OUT THE NEW ORGANIZATION

The new management, after a year's study, came to the conclusion that the company's goals would be better served by a complete separation of the manufacturing, sales, and engineering functions. This would permit a top manufacturing man to head up all manufacturing within a homogeneous group of products. It would likewise permit a strong sales personality, who might be devoid of manufacturing know-how, to spark the selling effort without being concerned directly with the problem of manufacturing or engineering the product. Such an arrangement would also permit the research and development group to spread its know-how over all products and thus relieve the manufacturing staff of all engineering problems except those pertaining directly to production.

The company's manufacturing activity was organized under two basic product groups. Tube operations were consolidated as one, while equipment manufacturing made up the other group. All products using circuits were included in the latter. Some of these were oscilloscopes, signal generators, mobile radios, industrial television, and engine analyzers.

The organization change for equipment manufacturing was undertaken first. The manufacturing manager heading up this activity now bases his production schedules on sales forecasts from the newly formed equipment sales division.

The manufacturing division sells to the sales division at an agreed-upon price which, besides covering the cost of materials, labor and overhead, must also include in its overhead charge an amount to cover interest on investment. This is a monthly charge of one-half of one per cent of the total cost of fixed assets and inventories used in manufacturing. Finished goods are not included as they become the property of the sales division immediately upon completion.

The sales division is broken down by product managers—one for each group of products requiring a similar type of effort. Industrial television, for example, is under a separate product manager since industrial applications of TV require field engineering and are sold through channels entirely different from those of any other products. Transfers from manufacturing become finished goods in the sales division and cost of sales on the sales profit-and-loss statement as they are sold. The sales division profit-and-loss statement picks up the usual deductions and allowances, selling expenses, advertising, commissions, and freight. In addition, it is charged for development engineering based on engineering development orders.

Finally, interest on investment is provided for. Here, as in

THOMAS S. DUDICK, a graduate of New York University, is management consultant for the Raytheon Company, Waltham, Massachusetts. He was budget director for Allen B. DuMont Laboratories, Inc., Clifton, N. J., when this article was written. He is author of a number of papers that have been published in THE CONTROLLER, the NAA Bulletin and Business Budgeting.

manufacturing, the rate charged is one-half of one per cent each month for receivables and finished inventories. Interest on investment is a means of distributing the corporate office costs. The advantage of this method is that it places an incentive on reduction of inventories. The corporate office, in turn, must hold its costs below the aggregate of interest charges made to all the divisions.

THE PROFIT-AND-LOSS STATEMENT

In preparing the operating statement at month-end, the manufacturing and sales operating costs are placed side by side in order to show the combined results for each product. Thus the profit-and-loss statement will show a profit which reflects the volume of orders released to the manufacturing group. If this volume is greater or less than that needed for complete absorption of the fixed costs of manufacturing, the profit will be increased or decreased accordingly, through allocation of over- and underabsorbed overhead. Management has chosen to do this in order to emphasize the sales divisions' responsibility to keep the factory loaded. The method of distributing the over- or underabsorbed overhead is demonstrated below:

	Labor in Production Schedule	*Labor Incurred*	*Difference*	*Difference x Fixed Ovhd. Rate*
Product A	$ 300,000	$300,000	—0—	—0—
Product B	300,000	100,000	(200,000)	(150,000)
Product C	100,000	50,000	(50,000)	(37,500)
Product D	100,000	150,000	50,000	37,500
Product E	200,000	200,000	—0—	—0—
	$1,000,000	$800,000	(200,000)	(150,000)

THE ANNUAL BUDGET

Initially, in preparing the budget for the coming year, each division prepares annual figures only. Working with annual amounts reduces the work substantially and cuts down the time required for preparation. The annual budget is reviewed carefully by the controller to determine whether the return on investment in inventories and fixed assets is within satisfactory limits. The divisional budgets are consolidated on an over-all company basis to determine whether the total company plan for the new year meets with management's approval. In the electronics industry a 25 per cent return on investment is considered desirable. If changes are required, keeping the figures in annual form facilitates revisions.

SALES ESTIMATES—THE STARTING POINT

Each product manager collects from his staff a realistic estimate of the sales which can be anticipated for the subsequent year. The pressure for realism is self-generated because the sales group realizes that an overoptimistic forecast bears the penalty of a corresponding amount of underabsorbed overhead. On the other hand, too conservative an estimate will cause the overhead rates used in transfer prices to be too high resulting in an inaccurate cost-of-sales ratio during the coming year.

Each product manager's sales estimate made up for the total year is then broken down by months on the product's normal seasonal pattern adjusted for known factors.

THE MANUFACTURING DIVISION BUDGET

As soon as sales estimates are approved, they are forwarded to the manufacturing division. The production control and methods departments evaluate the sales figures in terms of material and labor needed to produce each product. With these two elements of cost determined, overhead requirements are then calculated. In calculating overhead, individual budgets are prepared for each of the centers, i.e., production control, purchasing, accounting, assembly, quality control, etc. These are consolidated for a total equipment manufacturing budget and overhead rates are then determined.

THE SALES DIVISION BUDGET

Having established its annual sales level forecast by products, and knowing the cost of transfers made to it by manufacturing, the sales division calculates various other costs and deductions (appearing on the profit-and-loss statement in *Exhibit 1*). Engineering expense is estimated jointly by the sales division and the research and development division after evaluation of the plans for the coming year.

EXHIBIT 1

PRODUCT G

PROFIT-AND-LOSS STATEMENT — APRIL 1958

	Manufacturing Division	*Sales Division*	*Interdiv. Elimination*	*Combined Result*
Gross Sales	$	$200,000	$	$200,000
Less Returns		6,000		6,000
Net Sales	150,000	194,000	150,000	194,000
Cost of Sales				
Material	74,000	76,000	74,000	76,000
Labor	30,000	32,000	30,000	32,000
Overhead	36,000	37,000	36,000	37,000
Total Cost of Sales	140,000	145,000	140,000	145,000
Overhead Incurred	36,000			36,000
Overhead Absorbed	30,000			30,000
(Over) or Underabsorbed	6,000			6,000
Distribution Costs				
Selling Expenses		15,000		15,000
Advertising Expenses		1,000		1,000
Commissions Paid Out		2,000		2,000
Freight Out		500		500
Total Distribution Costs		18,500		18,500
Engineering Expense		12,000		12,000
Division Profit or Loss	4,000	18,500	10,000	12,500
Interest on Investment	5,000	8,000		13,000
Company Profit or Loss	(1,000)	10,500	10,000	(500)

SEPARATING THE FIXED AND VARIABLE COSTS IN MANUFACTURING

Upon consolidation and approval of the total company budget, the sales, manufacturing, and engineering divisions break down the annual overhead costs into a variable and fixed formula.

Much has been written on the subject of determination of variable and fixed costs by use of scatter charts, by the mathematical process of estimating the expense at the two limits of the normal operating range, and by use of the step or capacity method. None of these methods is used at DuMont. The scatter chart method was ruled out because it fails to recognize the basic precept that numerous major overhead costs (production control and purchasing, for example) are usually high in preparation for an increase in manufacturing activity and are on the decrease when manufacturing activity is reaching its peak. The result is a scatter pattern so erratic that no line of variability can be fitted to historical data.

The low and high method and step method were also ruled out. This was done because of the time required to estimate costs at numerous levels of operation which the company has not experienced recently on a sustained basis. The method now followed is tied directly to the figures contained in the annual budget figures. It does not require any estimating other than to determine how the annual figures break down between fixed and variable costs. To illustrate, let us extract from the budget

(Continued on page 56)

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the following annual payroll cost for the material control section of the production control department:

Job Classification	*Number of Employes*	*Total Annual Payroll*
Section Head	1	$ 7,000
Secretary	1	4,000
Planners	5	22,500
Material Handlers	8	30,000
Storekeepers	5	20,000
Total	20	$83,500

This represents the total payroll required to service an annual direct labor level of activity of $4,350,000.

DETERMINATION OF FIXED COSTS

In understanding how fixed costs are determined by DuMont now, it should be kept in mind that fixed costs used for budgeting are those costs which remain constant within the normal range of activity rather than the minimum or standby costs at zero activity. To use the fixed costs at standby level would result in a deceptive picture when attempting to reconcile volume variances.

With this as a background, let us assume that the department head lists the following personnel as being fixed overhead within the normal range of activity in the 12-month period.

Job Classification	*Number of Employes*	*Total Annual Payroll*
Section Head	1	$ 7,000
Secretary	1	4,000
Planners	2	11,500
Material Handlers	1	4,000
Storekeepers	1	4,800
Total	6	$31,300

The fixed cost, then, amounts to $31,300 per year.

DETERMINING THE VARIABLE COSTS

Now that the total payroll and the fixed portion are known, the variable costs are determined by subtracting the fixed costs from the total as follows:

Job Classification	*Number of Employes*	*Total Annual Payroll*
Planners	3	$11,000
Material Handlers	7	26,000
Storekeepers	4	15,200
Total	14	$52,200

At this point we know that the fixed cost is $31,300 per year or $626 per week. The weekly figure is arrived at by dividing the annual fixed cost by 50 weeks in order to spread the two-week-vacation cost over the remainder of the year. Fixed costs are expressed in terms of weekly figures because DuMont follows the equal-quarter accounting period made up of two four-week periods and one five-week period.

The next procedure is to budget the variable portion. The variable costs fluctuate with production activity as a percentage of direct labor, which in this operation is the best index. Dividing variable costs by direct labor provides a variable overhead rate as follows:

$$\frac{\$52,200 \text{ (variable costs)}}{\$4,350,000 \text{ (direct labor)}} = 1.2\%$$

This procedure is followed for all expenses in each department.

Upon completion, a schedule similar to *Exhibit 2* is prepared. This schedule summarizes the total annual costs, the fixed costs and the variable for each classification of expense, and the variable percentages to be used for forecasting the overhead at various levels.

EXHIBIT 2

1958 VARIABLE BUDGET AND OVERHEAD STANDARDS ANNUAL OVERHEAD EXPENSE

Division: Equipment Manufacturing
Department: Department A

	Total Annual Cost	*Fixed*	*Variable*	*Var. % of D. L.**
Salaries and Overtime	$271,597	$175,677	$ 95,920	2.667
Disability Payments	920	600	320	.009
Taxes—Payroll	8,510	5,550	2,960	.082
Insurance—Compensation	506	330	176	.005
Employe Benefits	3,588	2,340	1,248	.035
Supplies from Stores	200	200	—	—
Other Purchased Supplies	500	500	—	—
Office Supplies	7,500	7,500	—	—
Postage	50	50	—	—
Photos and Prints	1,500	1,500	—	—
Freight-In	68,000		68,000	1.890
Dues Subscriptions	150	150	—	—
Purchased Services	150	150	—	—
Insurance—Other	1,000	1,000	—	—
Travel	18,200	—	18,200	.506
Telephone	30,000	—	30,000	.834
Total Overhead Expenses	412,371	195,547	216,824	6.028
Work Order Charges	500	500	—	—
Allocated Credits	(56,915)	(56,915)	—	—
Total After Debits and Credits	$355,956	$139,132	$216,824	6.028

* Total Direct Labor Used As a Base = $3,597,000

FORECASTING AND CONTROL

The figures contained in *Exhibit 2* are the basis for forecasting overhead costs for various annual and monthly levels of activity. These are prepared in columnar form similar to that of *Exhibits 3* and *4*.

Exhibit 3 (annual basis) gives management the overhead costs for nine levels of activity ranging from $2,100,000 to $4,500,000 in direct labor annually. This is a wide range but it dramatizes the impact of volume on costs in a manner similar to that of a breakeven chart (which would start at zero activity and cover a much wider range).

Exhibit 4 has been prepared in a similar manner except that the figures cover a four-week period. In comparing the actual overhead costs for the month with the allowable costs shown for the applicable direct labor level, management has a simple and readily understandable basis for control.

CONTROL OF MATERIAL AND DIRECT LABOR

Material and direct labor are controlled in the factory by comparing actual cost with standard costs. In addition to this conventional method, the sales division, through its interest in transfer prices, utilizes a secondary control by analyzing the material and labor in the cost of transfers to them. Each product's profit-and-loss statement actually applies to a homogeneous group of products. It follows that the percentage relationship of material and labor in the cost of sales to sales is watched closely. The significance of material and labor as direct costs in the product, and the effect on the profit for which each product manager is responsible, raise questions which frequently result in cost-saving changes in design. This is particularly significant because the sales division initiates requests for changes in design. The sales group, being fully aware of customer desires, works closely with the engineering group. *(Cont. on p. 58)*

EXHIBIT 3

1958 BUDGET DEPARTMENT A

ANNUAL BASIS

	DIRECT LABOR LEVELS								
	$2,100,000	$2,400,000	$2,700,000	$3,000,000	$3,300,000	$3,600,000	$3,900,000	$4,200,000	$4,500,000
Salaries and Overtime	231,684	239,685	247,686	255,687*	263,688	271,689	279,690	287,691	295,692
Disability Payments	789	816	843	870	897	924	951	978	1,005
Taxes—Payroll	7,272	7,518	7,764	8,010	8,256	8,502	8,748	8,994	9,240
Insurance—Compensation	435	450	465	480	495	510	525	540	555
Employe Benefits	3,075	3,180	3,285	3,390	3,495	3,600	3,705	3,810	3,915
Supplies from Stores	200	200	200	200	200	200	200	200	200
Other Purchased Supplies	500	500	500	500	500	500	500	500	500
Office Supplies	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500	7,500
Postage	50	50	50	50	50	50	50	50	50
Photos and Prints	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500
Freight-In	39,690	45,360	51,030	56,700	62,370	68,040	73,710	79,380	85,050
Dues Subscriptions	150	150	150	150	150	150	150	150	150
Purchased Services	150	150	150	150	150	150	150	150	150
Insurance—Other	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000	1,000
Travel	10,626	12,144	13,662	15,180	16,698	18,216	19,734	21,252	22,770
Telephone	17,514	20,016	22,518	25,020	27,522	30,024	32,526	35,028	37,530
Total O/H Expenses	322,135	340,219	358,303	376,387	394,471	412,555	430,639	448,723	466,807
Work Order Charges	500	500	500	500	500	500	500	500	500
Allocated Credits	(56,915)	(56,915)	(56,915)	(56,915)	(56,915)	(56,915)	(56,915)	(56,915)	(56,915)
Total After Debits and Credits	$ 265,720	$ 283,804	$ 301,888	$ 319,972	$ 338,056	$ 356,140	$ 374,224	$ 392,308	$ 410,392
Overhead Rate	12.7%	11.8%	11.2%	10.7%	10.2%	9.9%	9.6%	9.3%	9.1%

*Var. % of D. L.**
2.667
.009
.082
.005
.035
—
—
—
—
1.890
—
—
—
.506
.834
6.028
—
—
6.028

* *Calculation Per Formula in Exhibit 2*
$3,000,000 × 2.667% (Variable) + $175,677 (Fixed) = $255,687

EXHIBIT 4

1958 BUDGET DEPARTMENT A

AT VARIOUS DIRECT LABOR LEVELS
FOUR-WEEK PERIOD

	DIRECT LABOR LEVELS											
	$200,000	$225,000	$250,000	$275,000	$300,000	$325,000	$350,000	$375,000	$400,000	$425,000	$450,000	$475,000
Salaries and Overtime	19,388	20,055	20,722	21,389	22,056*	22,722	23,389	24,055	24,721	25,388	26,054	26,721
Disability Payments	66	68	71	73	75	77	80	82	84	86	89	91
Taxes—Payroll	608	628	649	669	690	710	731	751	772	792	813	833
Insurance—Compensation	36	37	38	39	40	41	43	44	45	46	48	49
Employe Benefits	257	265	274	283	291	301	309	318	327	335	344	353
Supplies from Stores	16	16	16	16	16	16	16	16	16	16	16	16
Other Purchased Supplies	40	40	40	40	40	40	40	40	40	40	40	40
Office Supplies	600	600	600	600	600	600	600	600	600	600	600	600
Postage	4	4	4	4	4	4	4	4	4	4	4	4
Photos and Prints	120	120	120	120	120	120	120	120	120	120	120	120
Freight—In	3,780	4,253	4,725	5,198	5,670	6,143	6,615	7,088	7,560	8,033	8,505	8,976
Dues Subscriptions	12	12	12	12	12	12	12	12	12	12	12	12
Purchased Services	12	12	12	12	12	12	12	12	12	12	12	12
Insurance—Other	80	80	80	80	80	80	80	80	80	80	80	80
Travel	1,012	1,139	1,265	1,392	1,518	1,645	1,771	1,898	2,024	2,151	2,277	2,404
Telephone	1,668	1,877	2,085	2,294	2,502	2,711	2,919	3,128	3,336	3,545	3,753	3,962
Total O/H Expenses	27,699	29,206	30,713	32,221	33,726	35,234	36,741	38,248	39,753	41,260	42,767	44,273
Work Order Charges	40	40	40	40	40	40	40	40	40	40	40	40
Allocated Credits	(4,552)	(4,552)	(4,552)	(4,552)	(4,552)	(4,552)	(4,552)	(4,552)	(4,552)	(4,552)	(4,552)	(4,552)
Total After Debits and Credits	$ 23,187	$ 24,694	$ 26,201	$ 27,709	$ 29,214	$ 30,722	$ 32,229	$ 33,736	$ 35,241	$ 36,748	$ 38,255	$ 39,761

* *Calculation Per Formula in Exhibit 2*
$300,000 × 2.667% (Variable) + 4/50 of $175,677 (Fixed) = $22,056

EXHIBIT 5

1958 BUDGET — PRODUCT E

	Total	*Fixed*	*Variable*	*Variable % of Sales*
Gross Sales	$15,377,000	$ —	$ —	—
Less Discounts	74,000	—	74,000	.48%
Less Royalties	176,000	—	176,000	1.14
Less Allowances	89,000	—	89,000	.58
Net Sales	15,038,000	—	—	—
Cost of Sales	11,735,000	—	11,735,000	76.31
Gross Operating Profit	3,303,000	—	—	—
Selling Expense	980,000	980,000	—	—
Service Expense	220,000	—	220,000	1.43
Warehouse Expense	144,000	144,000	—	—
Advertising	881,000	496,576	384,425	2.50
Commissions	52,000	—	52,000	.34
Freight-Out (Not Applicable)				
Bad Debts	74,000	—	74,000	.48
Engineering and Product Design	212,000	212,000	—	—
Total Expense	2,563,000	1,832,575	730,425	4.75
Division Profit or Loss	740,000	—	—	—
Interest on Investment	264,000	264,000	—	—
Company Profit or Loss	476,000	—	—	—
Total Cost	$14,901,000	$2,096,575	$12,804,425	83.26%

Breakeven Sales = $2,096,575 divided by (100.00% — 83.26%) = $12,524,000

THE SALES DIVISION— SEPARATING THE FIXED AND VARIABLE COSTS

Fixed and variable costs in the sales division are separated in a manner similar to that followed in manufacturing—the major difference being that the level of activity is based on sales rather than direct labor. Cost of sales, discounts, royalties, freight out, commissions, service expense and interest on investment are considered completely variable. Most of the remaining cost is considered fixed. Where certain costs such as advertising, for example, are partly variable and partly fixed, the formula takes both into account.

Exhibit 5 shows the total annual costs for all items which appear in the profit-and-loss statement. As in manufacturing, it also lists the fixed costs, the variable costs and the variable as a percentage of total sales for the year. The breakeven sales volume is shown on the last line of this exhibit.

Exhibit 6 shows the profit-and-loss statement for levels of sales at intervals of $500,000 ranging from $11.5 million per year to $16 million. It illustrates through a columnar profit-and-loss spread the effect of volume on profits.

Exhibit 7 also shows the profit-and-loss spread for the various volumes of sales on a four-week-period basis. Thus, as each month's profit-and-loss results become available, the product manager will consult the appropriate sales level column in *Exhibit 7* and compare the allowable costs with the actual.

DETERMINATION OF THE OVERHEAD RATE

With the fixed and variable formula now determined, we are ready for the final step in development of the budget—the determination of the overhead rate to be used in valuing inventories and preparing cost estimates for bidding.

The first step is to determine the level of activity at which the overhead rate will be calculated. To see how the proper level of activity upon which to base an overhead rate is deter-

EXHIBIT 6

1958 BUDGET — PRODUCT E
AT VARIOUS SALES LEVELS
ANNUAL BASIS

Gross Sales	$11,500,000	$12,000,000	$12,500,000	$13,000,000	$13,500,000	$14,000,000	$14,500,000	$15,000,000	$15,500,000	$16,000,000
Less Discounts	55,200	57,600	60,000	62,400	64,700	67,100	69,500	71,900	74,400	76,800
Less Royalties	131,500	137,300	142,900	148,700	154,400	160,200	165,900	171,600	177,300	183,000
Less Allowances	66,300	69,100	72,100	74,900	77,900	80,700	82,600	86,500	89,300	92,200
Net Sales	11,247,000	11,736,000	12,225,000	12,714,000	13,203,000	13,692,000	14,182,000	14,670,000	15,159,000	15,648,000
Cost of Sales	8,775,650	9,157,200	9,538,750	9,920,300	10,301,850	10,683,400	11,064,950	11,446,400	11,827,950	12,209,500
Gross Operating Profit	2,471,350	2,578,800	2,686,250	2,793,700	2,901,150	3,008,600	3,117,050	3,223,600	3,331,050	3,438,500
Selling Expense	980,000	980,000	980,000	980,000	980,000	980,000	980,000	980,000	980,000	980,000
Service Expense	164,500	171,600	178,700	185,900	193,000	200,200	207,350	214,500	221,650	228,800
Warehouse Expense	144,000	144,000	144,000	144,000	144,000	144,000	144,000	144,000	144,000	144,000
Advertising	784,076	796,576*	809,076	821,576	834,076	846,576	859,076	871,576	884,076	896,576
Commissions	38,870	40,560	42,250	43,940	45,630	47,320	49,010	50,700	52,390	54,080
Freight-Out (Not Applicable)										
Bad Debts	55,200	57,600	60,000	62,400	64,800	67,200	69,600	72,000	74,400	76,800
Engineering and Product Design	212,000	212,000	212,000	212,000	212,000	212,000	212,000	212,000	212,000	212,000
Total Expense	2,378,646	2,402,336	2,426,026	2,449,816	2,473,506	2,497,296	2,521,036	2,544,776	2,568,516	2,592,256
Division Profit or Loss	92,704	176,464	260,224	343,884	427,644	511,304	596,014	678,824	762,534	846,244
Interest on Investment	264,000	264,000	264,000	264,000	264,000	264,000	264,000	264,000	264,000	264,000
Company Profit or Loss	$ (171,294)	$ (87,536)	$ (3,776)	$ 79,884	$ 163,644	$ 247,304	$ 332,014	$ 414,824	$ 498,534	$ 582,244

* *Calculation Per Formula in Exhibit 5*
$12,000,000 × 2.50% (Variable) Plus $496,576 (Fixed) = $796,576

EXHIBIT 7

1958 BUDGET PRODUCT E
AT VARIOUS GROSS SALES LEVELS
FOUR-WEEK PERIOD

Gross Sales	$600,000	$800,000	$1,000,000	$1,200,000	$1,400,000	$1,600,000	$1,800,000	$2,000,000	$2,200,000	$2,400,000
Less Discounts	2,880	3,840	4,800	5,760	6,720	7,680	8,640	9,600	10,560	11,520
Less Royalties	6,840	9,120	11,400	13,680	15,960	18,240	20,520	22,800	25,080	27,360
Less Allowances	3,480	4,640	5,800	6,960	8,120	9,280	10,440	11,600	12,760	13,920
Net Sales	586,800	782,400	978,000	1,173,600	1,369,200	1,564,800	1,760,400	1,956,000	2,151,600	2,347,200
Cost of Sales	457,860	610,480	763,100	915,720	1,068,340	1,220,960	1,373,580	1,526,200	1,678,820	1,831,440
Gross Operating Profit	128,940	171,920	214,900	257,880	300,860	343,840	386,820	429,800	472,780	515,760
Selling Expense	78,600	78,600	78,600	78,600	78,600	78,600	78,600	78,600	78,600	78,600
Service Expense	6,840	9,120	11,400	13,680	15,960	18,240	20,520	22,800	25,080	27,360
Warehouse Expense	11,520	11,520	11,520	11,520	11,520	11,520	11,520	11,520	11,520	11,520
Advertising	54,724	59,724*	64,724	69,724	74,724	79,724	84,724	89,724	94,724	99,724
Commissions	2,028	2,704	3,380	4,056	4,732	5,408	6,084	6,760	7,436	8,112
Freight-Out (Not Applicable)										
Bad Debts	2,886	3,848	4,810	5,772	6,734	7,696	8,658	9,620	10,582	11,544
Engineering and Product Design	16,980	16,980	16,980	16,980	16,980	16,980	16,980	16,980	16,980	16,980
Total Expense	173,578	182,496	191,414	200,332	209,250	218,168	227,086	236,004	244,922	253,840
Division Profit or Loss	(44,638)	(10,576)	23,486	57,548	91,610	125,672	159,734	193,796	227,858	261,920
Interest on Investment	21,120	21,120	21,120	21,120	21,120	21,120	21,120	21,120	21,120	21,120
Company Profit or Loss	$ (65,758)	$ (31,696)	$ 2,366	$ 36,428	$ 70,490	$ 104,552	$ 138,614	$ 172,676	$ 206,738	$ 240,800

* *Calculation Per Formula in Exhibit 5*
$800,000 × 2.50% (Variable) Plus 4/50 of $496,576 = $59,724

mined, let us assume that the investment in inventories (exclusive of valuation reserves) and the original cost of manufacturing fixed assets is as follows:

Inventories	$12,000,000
Mfg. Fixed Assets	3,000,000
Total	$15,000,000

This type of investment is considered controllable because inventories are directly determined by the factory and sales departments. At the same time, the manufacturing fixed assets are controllable, in the sense that the better the utilization of equipment, the lower the investment needed for additional equipment.

A rule of thumb which may be applied to the electronics industry is that an annual sales volume equivalent to two and a half to three turns of the controllable investment per year will provide sufficient volume to assure a competitive manufacturing overhead rate.

Exhibit 8 illustrates how the controllable investment is converted to equivalent annual sales at various levels—the sales levels being determined by the number of turns of investment from 2.2 to 3.0 turns per year. The range stops at 3.0 turns because it would require additional fixed assets to go beyond this point. Using the first column as an example, if $15 million in investment is turned over 2.2 times, the resulting annual sales figure is $33 million. Direct labor, which is the base for calculating the overhead rate, is taken to be 10 per cent of sales—the same mix of sales being assumed at all levels. Fixed costs were determined elsewhere to be $1,850,000 per year while variable costs were determined to be 70 per cent of direct labor.

With the variable portion of the overhead rate determined to

EXHIBIT 8

CALCULATIONS OF OVERHEAD RATES
AT SEVERAL LEVELS OF ACTIVITY

Investment Turns Per Year	2.2	2.4	2.6	2.8	3.0
Sales Volume Based on Above	$33,000,000	$36,000,000	$39,000,000	$42,000,000	$45,000,000
Labor Content—10%	3,300,000	3,600,000	3,900,000	4,200,000	4,500,000
Overhead Cost					
Fixed Cost	1,850,000	1,850,000	1,850,000	1,850,000	1,850,000
Variable Cost	2,310,000	2,520,000	2,730,000	2,940,000	3,150,000
Total	4,160,000	4,370,000	4,580,000	4,790,000	5,000,000
Overhead Rate					
Fixed	56%	51%	47%	44%	41%
Variable	70	70	70	70	70
Total	126%	121%	117%	114%	111%

be 70 per cent, the next step is to calculate the fixed portion. (This rate is calculated separately because it is used to spread over- and underabsorbed overhead to the various products.) The fixed overhead rate is calculated by dividing the direct labor for each level into the fixed cost of $1,850,000. In the example, *Exhibit 8*, the overhead rate ranges from 111 per cent to 126 per cent. The controller, in making his decision as to which rate to use, found that the particular product under review was earning a profit on sales of 9 per cent which was considered to be satisfactory. Anything over this amount would invite competition. As a result, the mark-up factor in pricing was frozen at a point which would realize 9 per cent profit on sales, with a volume of sales set at a level which would result in a return on investment of 25 per cent.

The determination of the necessary sales volume is simply a matter of mathematics, since 25 per cent divided by 9 per cent equals 2.8. This means that the investment of $15 million must be turned 2.8 times per year, requiring a sales volume of $42 million.

SUMMARY

Budgeting for the year in total and presenting the annualized budget to management for its approval has substantially cut the time required for preparation. The elimination of the calculation of numerous individual figures is now possible. This operation had relegated the controller's group to the role of statistical clerks who were required to spend so many hours compiling and accumulating the necessary statistics that they were left no time for exercise of judgment or for evaluation of the figures while the budget was being formulated.

Another advantage of preparing the budget in annual form, made known recently by two department managers, was the way it revealed—to their amazement—how much it cost to operate their departments. This observation was crystallized by looking at concise and meaningful figures.

The preparation of separate profit-and-loss statements for manufacturing and for sales has the effect of setting up each group as if it were in business for itself. Where excess manufacturing costs previously were buried in cost-of-sales figures in a composite statement, the sales group can now scrutinize the transfer prices readily. Frequently it sends its field engineers into the factory to determine whether certain tight specifications need be so tight, and whether change of design or use of substitute material is indicated. In the past, the sales department might have been tempted to sell merely to increase volume, without regard to the profitability of the items or size of the resulting production run. Now it makes certain that the items which are sold will have sufficient margin to realize an adequate return. Likewise, the sales department realizes that the factory must be kept loaded with optimum production runs in order to keep transfer prices competitive.

The manufacturing manager is also more conscious of performance because he realizes that his results will be clearly spelled out in a separate statement. It is true that standards and variances from standard accomplish the same type of control and constitute an important analysis function in the controller's department. But being responsible for results on a profit-and-loss statement which is scrutinized not only by the officers of the company but by the board of directors as well, creates an aura of responsibility not readily attainable through reporting by conventional methods.

The procedures outlined here can be applied to almost any similar corporate structure manufacturing and selling a commercial product. Many companies have sales organizations which cross product lines—thus diffusing the profit-and-loss responsibility to an even greater extent than when a sales organization exists for each individual product.

The keystone to success of any type of control is management follow-up. Inasmuch as the profit-and-loss statement is a key focal point of any management control, the extent to which responsibility can be assigned for profit-and-loss results will determine the measure of control exercised over each major segment of the organization.

This Survey Answers Your Questions

How many executives report directly to control executives?
For what functions is the control executive responsible?
Where are control executives' responsibilities stated?
What is his educational and training background?
What is the typical control executive's age?
Who hires the control executive?
How big is the control executive's department?
What is his employment and experience background?
To whom is the control executive directly responsible?
On what management committees do control executives serve?

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THE MANAGER LOOKS AT

Profitability Measurements

A method of expressing the profit on an investment, after depreciation and taxes, in terms of the arithmetic for computing "yield to maturity" for funds

W. Bernard Thulin

ONE OF THE QUESTIONS confronting the management of an enterprise is perennially troublesome: *Should we undertake this project?* The project might be the construction of a new plant, or an addition to an existing one; the institution of a new product line; the establishment of a data-processing center; the purchase of an additional or replacing machine; or any one of the multitude of projects suggested in the ordinary operation of the enterprise that requires a sizable outlay of funds and that may be expected to be profitably employed for a number of years.

There are usually many reasons other than financial which argue for or against undertaking a proposed project at any particular time. Indeed, in some cases, financial considerations can be overshadowed when management objectives for long-term growth, market position, diversification, corporate reputation or pride, and similar objectives loom large in the decision. Still, in a great many situations the manager wants to know: *How profitable will this project be?* Or, to state the question another way: *How will this project affect the company's profits, not only for the entire life of the project, but during the immediate future?* Even when the decision will not finally hinge on profitability, it may be significant for the manager to know whether the project will have a directional effect upward or downward on the rate of profits.

Before any project can be undertaken the manager must know where, and at what terms, the required funds are available. Before the project can be intelligently appraised, certain facts and estimates must be at hand. The manager must know how much money it will take to get the project started, how much the project will increase or decrease the company's gross sales or revenues, how much the sales expense and other operating expenses will increase, what extra taxes the project will entail, how much additional depreciation expense will be required, and finally how all these estimates will net out to change the company's income, or profits.

If the project represents an entirely new venture all these estimates should be in terms of incremental amounts; that is, what capital will be needed (both for investment and for working capital) and what additional revenues, expenses and taxes will be generated as the result of undertaking the venture.

If the project represents a replacement, or if there is some reaction on the existing operations because of undertaking it, all the estimates should be net; that is, the gross increase in capital less any capital returned through salvaging old equipment; the gross increase in revenues less any revenues lost through retirement of the old equipment; and the gross increase in expenses less any expenses avoided because of the retirement of the old equipment. These in and out, or plus and minus, effects should be estimated realistically, as they will occur during the life of the project. These estimates, then, form the raw material out of which the profitability study can be constructed.

FIRST HURDLE

At this stage the manager faces his first hurdle. He must decide if he wants to go beyond the immediate effect the project will have on the company's balance sheet and income statement; that is, he must decide if he wants to know what this project will "really do" for the company financially over selected periods of time. This is sometimes not an easy decision, because a manager must always start with the project's effect on the company's income statement. Yet he may not always make the soundest financial decision for the enterprise by looking only at the immediate effect on the income statement. The basic intent of the profitability study is to show how profitable a project really is, taken by itself, in terms the investor might use.

Even though corporate bookkeeping and other profitability measurements may reflect the same ultimate results, the routes by which they get there may be quite different. It is not unusual for a project to appear to be doing better or worse (according to the income statement for its first few years) than it really is, financially, for the company.[1]

Consider, for example, the conventional distinction that accountants make between items which are recorded as capital and those shown as expenses. There may be extensive make-ready or special site preparation or extra maintenance or training costs, technically recorded as expenses, which are really a part

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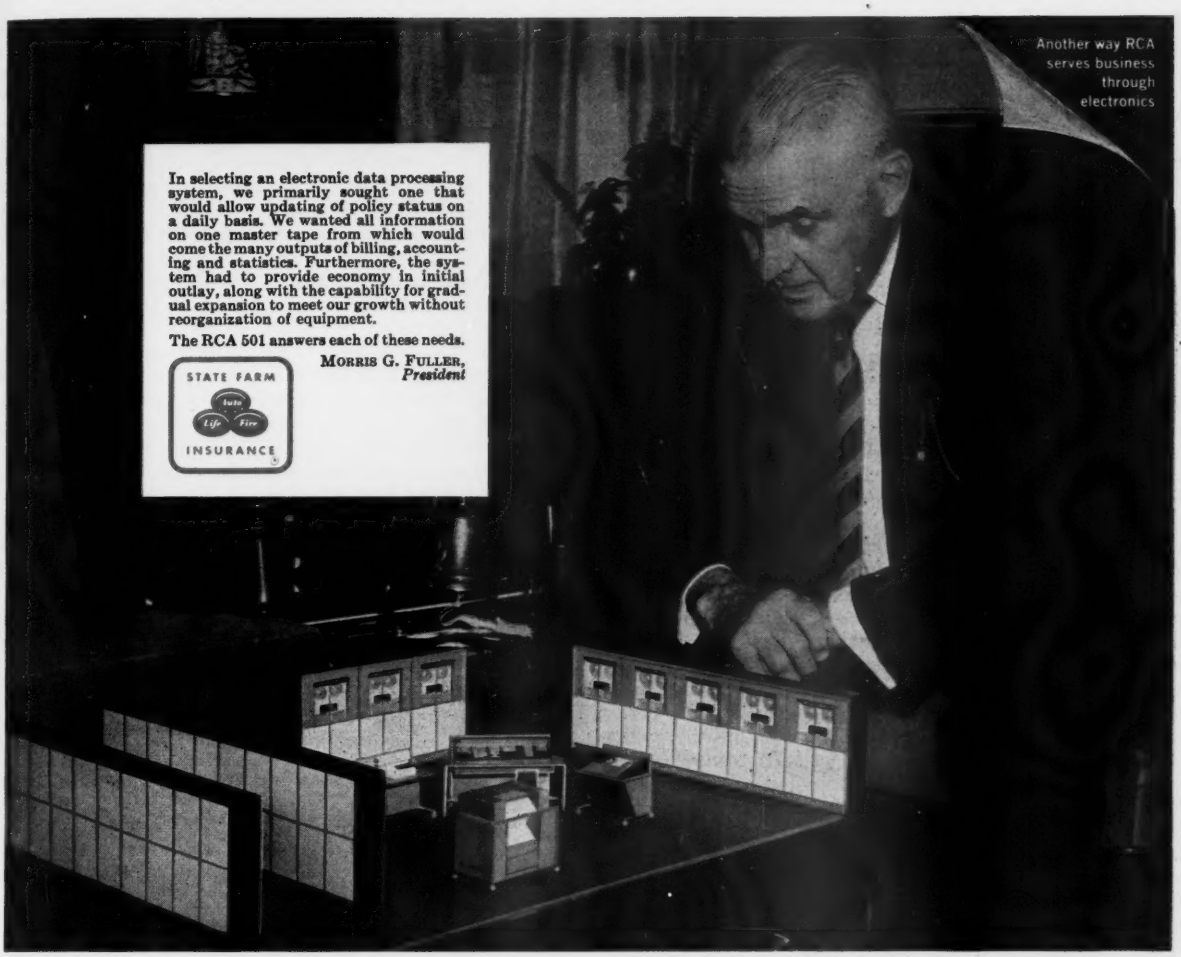
[1] This problem is not unlike the "real" effect as distinguished from the "booked" effect of various inventory methods, or economic versus booked depreciation, or accelerated depreciation for tax deferment, or the restatement of assets in terms of devalued dollars. The practical manager has had to learn to appreciate, evaluate and often make decisions as to the effects on profits in terms other than those shown on the official financial statements of his business.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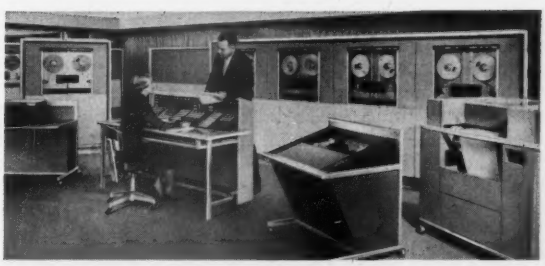

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of the money needed to get a project under way. If such costs are large they should be considered, for study purposes, as part of the initial capital required and recovered through depreciation charges in the profitability computations. Thus, in measuring profitability in terms of profit on investment, or return on capital, the corporate books may show one thing but the appraisal of the project, as a single undertaking, may dictate a different classification of the funds paid out.[2] This same sort of reasoning will apply to the treatment of depreciation charges where the books may show one "contour" (i.e., allocation method) for recording depreciation, and the appraisal of the project as an entity may suggest another contour of depreciation.

THE MANAGER'S RESPONSIBILITY

At the outset, therefore, the manager should recognize that profitability measurements do not necessarily use the same techniques or definitions as the accountants who will record the transaction on the official books of the company, once the project is undertaken. This should not be too disturbing, though, if the manager can reconcile himself to the fact that what he really is doing in making the decision on the project is acting as agent or trustee, at least morally, for the funds the investor will put into this project. The investor wants to know what his profits will be on this project, taken by itself, after making proper provision for the dissipation of his capital as the assets representing the project deteriorate over the project's life. The manager has a twofold responsibility. First, he must be sure to protect the integrity of the investment by proper depreciation charges. Second, he must identify the profits, as honestly and as accurately as possible, over the time period (usually years) that the project will "live." Unless the profitability measurement used by the manager will accomplish these two objectives, regardless of how the project's impact will be recorded on the company's books, the manager is not fully discharging his responsibility to the investor who puts up the money for the undertaking.

Perhaps the manager will want to know the "real" effects in addition to "booked" effects. He then should understand that the estimates used for one purpose may not serve the other. For purposes of this discussion, let us assume that the primary concern of the manager is the incremental[3] profitability effects and that we have at hand firm and accurate estimates prepared for this purpose.

TECHNIQUES AVAILABLE

For years many businesses have used short-cut methods of determining profitability—often fairly successfully. The payback or payout method (i.e., the number of years it will take for the cash flow to repay the original investment) is one of the most often used. It is a blunt tool, but it will sometimes serve. Rate of return methods have been used, with a host of variations, but basically they most often show the average annual profits over the life of the project related either to the initial capital required, or to the average capital tied up during the life of the project. For instance, if a project will require $10,000 of investment, live 10 years, have no salvage value, and produce a total of $10,000 profits over its life, this would be an annual average profit of $1,000. Related to the initial capital of $10,000 the return would be 10 per cent. Related to average capital of $5,000 (i.e., one-half the initial capital on the assumption that the original capital is returned in equal annual installments via depreciation accruals) the return would be 20 per cent.

Yardsticks such as these are very crude, and simply will not serve for the manager who is conscientiously trying to discharge his responsibility to the investor. There are two obvious reasons why these crude yardsticks will not suffice. First, they do not properly evaluate profits over time, that is, the profit contour. Second, they assume either that the original investment is repaid (the average capital method) or that the capital is tied up continuously in this or an exactly comparable project (the initial capital method). Both these assumptions are usually wrong.

Discounted Cash Flow. Another approach that is being used more and more these days is the discounted cash flow method. This has the advantage of greater precision, in that it does recognize time as an element. Any appraisal of profitability should recognize that dollars of investment and dollars of profit associated with a project are not comparable unless they are discounted or compounded to the same point in time. The discounted cash flow method starts with the cash flow (i.e., profits after taxes, but before depreciation) and discounts these annual flows to present worth, using trial and error interest rates until a rate is found which will make the total of the discounted annual cash flows equal the original cash outlay. This interest rate then represents the profitability of the project. Take another simple case as an example, this time using a project requiring $1,000 of investment, with no salvage value and a life of only two years:

TABLE A

Example of Discounted Cash Flow Method

Cash Outlay for Project—$1,000

	(1) Cash Flow (after taxes but before depreciation)	(2) Discount Factor at 50% Rate	(3) Present Worth of Cash Flow Discounted at 50% (2) × (3)
Year 1	$900	.667	$ 600
Year 2	900	.444	400
		Total	$1,000

Since the discounted cash flow totals $1,000, which is the cash outlay for the project, the project's profitability can be stated at 50%. This can be proved by the following simple arithmetic:

TABLE B

Proof of Discounted Cash Flow Method

	(1) Capital Employed by Project	(2) Cash Flow (after taxes but before depreciation)	(3) Interest on Capital Employed at 50% (1) × 50%	(4) Balance of Cash Flow Available to Repay Principal (2) − (3)
Year 1	$1,000	$900	$500	$400
Year 2	600	900	300	600

This proof shows that $400 of the original outlay can be repaid at the end of Year 1 leaving $600 still tied up on the project during year 2.[4] At the end of Year 2, 50% interest is paid out on the $600 and the balance of the original outlay is paid off. Thus, during the two-year life of the project the investor has been repaid his original outlay and at the same time profits, or interest, of 50%. Thus, the method indicates that this project has a profitability rate of 50%.

Two aspects in this simple example become clear when we study the arithmetic. One is that the repayment of the principal, which is another way of looking at what the accountant would call depreciation charges or accruals, depends on the amount of money left over after the interest, or profit, is paid on the

[2] For items classified as expense there is, of course, a tax saving. This should be reflected as a credit to the initial outlay required.

[3] Incremental amounts directly attributable to this project should not necessarily include a full pro rata share of existing overhead or other "burdens" that this project may carry under the standard bookkeeping techniques used by the firm.

[4] This simple example assumes interest and repayment are handled only at the end of each year; that $900 is received in one lump sum at the end of each year. While there are method refinements which provide for spreading these payments over the year, the basic theory remains unchanged.

amount of capital tied up in the project for the calendar year. The discounted cash flow theory assumes that the appropriate contour of depreciation accruals is what we can "afford" to pay back. This is not necessarily the same as the contour of depreciation accruals that will protect the integrity of the investor's original outlay. We shall have more to say about this later.

The other aspect that is clear from a study of the example is that the theory assumes the investor *is* paid back; in other words, that the depreciation accruals are, in fact, used to repay the principal. This is one reason the discounted cash flow method generally fails to measure profitability from the viewpoint a manager should use. Depreciation accruals are not used to repay investments.

Reinvestment Assumptions. A manager who makes the decision to commit capital to a project is, in most cases, making a decision for the initial investment of *permanent,* or long-range, capital in the enterprise he is managing. When and as this capital is "repaid" via depreciation accruals, it is re-invested in the enterprise, either in other projects then available or as working capital. Using this thesis, the question the manager should ask is not simply *"How profitable is this project?"* but *"What will the outlay required for this project earn for the investor over this project's life?"*[5] There may well be crucial variations in the answers to these two different questions.

For instance, if you tell me I can invest $10,000 in a five-year project, with a profitability rate of 15 per cent as measured by the discounted cash flow method, this does not mean that you will keep my $10,000 for five years and pay me interest, or profits, of $1,500 for each of those five years. It merely tells me that this project will pay 15 per cent return annually on the unpaid balance of the initial outlay and pay back the principal in installments each year. Moreover, I, as the investor, will have nothing to say about the size of the annual installments by which the principal is repaid. These installments will be dictated entirely by the profit contour of the project. You may pay back the principal rapidly in the early years, or slowly at first with large payments in the later years. The method assumes that the investor will be completely indifferent to the contour of these repayments, presumably on the assumption that there will be other projects he can find where he can also get a 15 per cent profitability rate and thus earn 15 per cent over the five years on his entire $10,000.

This brings us to the heart of the assumptions underlying the discounted cash flow method. It assumes either that the repayments of the principal (or the depreciation accruals if you wish to think of them in these terms) can be invested at the identical profitability rate elsewhere, or completely disregarded. If the manager, acting for the investor, can conscientiously make either of these assumptions, and if he can also accept the depreciation contour the method produces, then he can satisfactorily use the discounted cash flow method for measuring profitability. Otherwise, he should search for some other measure.

Further Comments on Discounted Cash Flow Method. The discounted cash flow method is one way of computing a rate of return when we know how much initial capital is invested and what the cash flow will be, by years, during the life of the project. Working with the three items (the capital, the cash flow and time) the problem is to determine a rate of return.

But there is a complication. The cash flow comprises two elements. The cash flow includes both interest and repayment of capital, or as the accountants would label the two elements, profit and depreciation. In the discussion in this section let us use these terms, "profit" and "depreciation."

[5] The question could also be asked as *"What will the outlay required for this project earn for the investor if it is committed as permanent capital to this enterprise?"* The answer then hinges on the effect that this project, for its particular life and earning rate, will have on the earning rate assumed for internal funds indefinitely extended. This would be a legitimate question, easily answered if a permanent earning rate for internal funds can be assumed. But this question holds less interest for the practical manager who may not wish to extend his appraisal beyond the life of this particular project.

Rate of return is the relationship of profit to investment over time. Before a rate of return can be computed, the cash flow must be broken down between profit and depreciation.

Consider the simple example shown in *Table A.* With initial capital of $1,000 the cash flow is $900 for each year of a two-year project life. As we saw in *Table B,* the discounted cash flow method breaks down the cash flow between profit and depreciation as follows:

TABLE C

Breakdown of Cash Flow

	Cash Flow	Profit	Depreciation
Year 1	$900	$500	$400
Year 2	900	300	600

And it was on the basis of this breakdown that the rate of return of 50 per cent was determined on the unpaid balance of the initial capital, thus:

TABLE D

Rate of Profit Using Depreciation Contour Dictated by Discounted Cash Flow Method

	Unpaid Balance	Profit	Rate of Return
Year 1	$1,000	$500	50%
Year 2	600	300	50%

Since the rate of return is 50 per cent for each year, the entire project can be said to show a 50 per cent return (i.e., profitability). The discounted cash flow method always shows the maximum rate of return that can be uniformly maintained for each year of the project's life. The method is designed, mathematically, to produce the highest uniform (i.e., level) rate of return that can be computed for any given cash flow. To produce this maximum return the initial capital must be "paid back" just as rapidly as possible. In other words, the amount allocated to depreciation for each year must be the highest amount that is consistent with maintaining a level rate of return.

The discounted cash flow method mathematically produces a depreciation contour for every project. In the simple case we have been using, the method determines that the depreciation contour should be $400 the first year and $600 the second year. No other depreciation contour will produce a 50 per cent rate of return for each of the two years. When they use this method, the accountants are abdicating their responsibility for determining the depreciation contour that should apply to the project. As the depreciation contour is changed, so also will the profit contour be changed. And as the profit contour is changed, so also will the rate of return be changed. We can conclude then that unless the accountant approves the depreciation contour mathematically produced by the discounted cash flow method, he cannot approve the rate of return the method produces.

The rate of return for any project can be determined only when the profit has been determined. It has taken the accounting profession at least half a century to come to some area of agreement as to how profits should be determined. One of the terms of agreement has generally been that depreciation charges should *not* be related to profits. In the earlier days of accounting, a common rule was "no profits—no depreciation." The adoption of the principle of continuous depreciation unrelated to profits took many years to crystallize. Yet by using the discounted cash flow method for determining future profitability we are, in effect, selecting a depreciation contour that is directly related to the project's profits. Under this method, as the cash flow changes, both profits and depreciation change, because the method interrelates them.

Consider again the simple case of $1,000 investment with $900 cash flow for each of the two years. Suppose we find that the first year's cash flow will be only $800 instead of the $900 first estimated. Using the discounted cash flow method, we

would recompute the profitability and find it to be 43% instead of 50%. The mathematical process of recomputing the profitability also recomputed the depreciation contour. Now, instead of a contour of $400 the first year and $500 the second, we find the method shows $370 the first year and $630 the second year. The depreciation contour changes because the cash flow changes; or, saying it another way, depreciation changes when profits change.

There are many accepted and acceptable ways of determining a depreciation contour for an asset, for a group of assets, or for a proposed project. What is acceptable is largely a matter of judgment. A contour that will properly allocate costs and provide for capital wastage does not depend on the profits generated. In fact, there may be little or no profits in any one year. This fact should not deter us from showing the proper depreciation charges for the year.

Suppose, in our simple example, the accountant and the manager have determined that for this project straight-line depreciation is appropriate. This means that depreciation should be shown at $500 for each of the two years. With a cash flow of $900 each year, this means that profits will be $400 each year. The rate of return then changes as follows:

TABLE E

Rate of Profit Using Straight-Line Depreciation

	Unpaid Balance	Profit	Rate of Return
Year 1	$1,000	$400	40%
Year 2	500	400	80%

This method shows a higher return on a smaller unpaid balance for Year 2 than in *Table D. Which is better for the investor who put up the initial capital of $1,000?* Obviously, we cannot say whether he would rather have a small balance invested at a high return than a larger balance at a lower return, unless we know what the alternatives are. *How profitably can the amounts "paid back," that is, the depreciation, be invested?* It is only when we know the answer to this question that we can determine the profitability of the original investment.

No Standard Method Always Proper. At this point the manager must recognize that he cannot delegate the profitability measurement to a subordinate who will use a method that has been "standardized." The method may have to change over the years as the business changes; the method may have to be adapted in some aspects to a particular project, and it certainly must be one that is applicable to the particular business. Some of the arithmetic will be determined by decisions only the manager can make, as will be clear when we discuss the suggested method.

COMPOSITE EARNINGS-YIELD METHOD

The measure of profitability we want is one that will state the rate of profit the investor can earn for the life of the project on the total capital outlay a given project will require. The profits should be computed after adequate provision for wasting of capital (i.e., depreciation accruals). In other words, the method should always protect the integrity of the investment and state the profits correctly for each year during the life of the project.[6] The protection of the original investment through depreciation accruals for purposes of the profitability study will be discussed in some detail later.

The method outlined herein might be called a "composite earnings-yield" approach. The method expresses the profit on the project, after depreciation and taxes, in terms of the arithmetic for computing "yield to maturity" for bonds. In words the manager might use, the method finds the discount rate that will make the present worth of all future earnings, plus the present worth of the repayment of the initial capital at the end of the project's life, exactly equal to the dollars the investor puts up to get the project started. Suppose, for example, we had the detailed work papers on a $10,000, five-year project, showing earnings of $1,400 each year:

TABLE F

14% Yield Demonstration

A $10,000 project to live five years:	
Present worth of all earnings on the investor's $10,000 during the next five years while this money is invested in the business, discounted at 14 per cent	$ 4,810
Present worth of the $10,000 that will be returned to the investor five years hence at the end of this project's life, discounted at 14 per cent	5,190
Total	$10,000

In the above example it should be understood that the profitability rate of 14 per cent was found by trial and error, and that it represents a composite profit rate not only of the profits directly flowing from the project but also earnings on that portion of the cash flow represented by the depreciation reserve (or depreciation allowance as it is often called) as this reserve will be built up during the five years of the project's life. The method assumes that the investor will receive all profits, both from the project and from the reinvested funds represented by the depreciation reserve; that is, that none of the profits (but only the reserve itself) is reinvested in the business.[7]

It may be evident, at this point, that the only basic differences between the composite earnings-yield and the discounted cash flow methods are the following:

1. The discounted cash flow method assumes that the depreciation accruals are returned to the investor at whatever pattern the project's earnings permit. The composite earnings-yield method provides for whatever pattern of depreciation accruals the manager deems appropriate.
2. The discounted cash flow method does not recognize the rate of profit the investor may receive on any of his original capital returned to him during the life of the project. The composite earnings-yield method estimates the earnings on the funds made available through depreciation accruals and adds these to the profits on the project.

Importance of Depreciation. The rate of depreciation accruals is important in using the composite earnings-yield method. Not only does the contour of the depreciation accruals affect the annual profits on the project, but the contour also determines how much is in the depreciation reserve, and for how long the increasing amount in the reserve can be earning extra profits for the investor. The contour to be used is a judgment decision pertinent to the particular project. The manager who will use the profitability rate determined by the study should participate in the decision as to the depreciation contour to be used. The depreciation contour to be used for the project should be independent of the general method used by the company in determining depreciation charges on its income statement or for tax purposes.

The objective is to reflect depreciation accruals on this particular project in the investor's terms; that is, whatever accruals will properly allocate costs and at the same time protect his original investment. In most cases, the firm's usual method will be applicable, because it will satisfactorily allocate costs and at the same time adequately cover physical depreciation, obsolescence or other wastage—often amply so. But for a specific project there may be factors that dictate more rapid depreciation accruals than provided by the firm's normal method. If so, the manager should choose the accelerated contour. Always the objective is to state the profits the project will produce, as honestly and as accurately as the manager's judgment permits. The distribution of these profits over time is a direct responsi-

(Continued on page 80)

[6] During periods of inflation depreciation accruals which recover only original cost dollars may not adequately protect the original investment. This is a problem beyond the scope of a profitability measurement method.

[7] This point is covered more fully later in the discussion.

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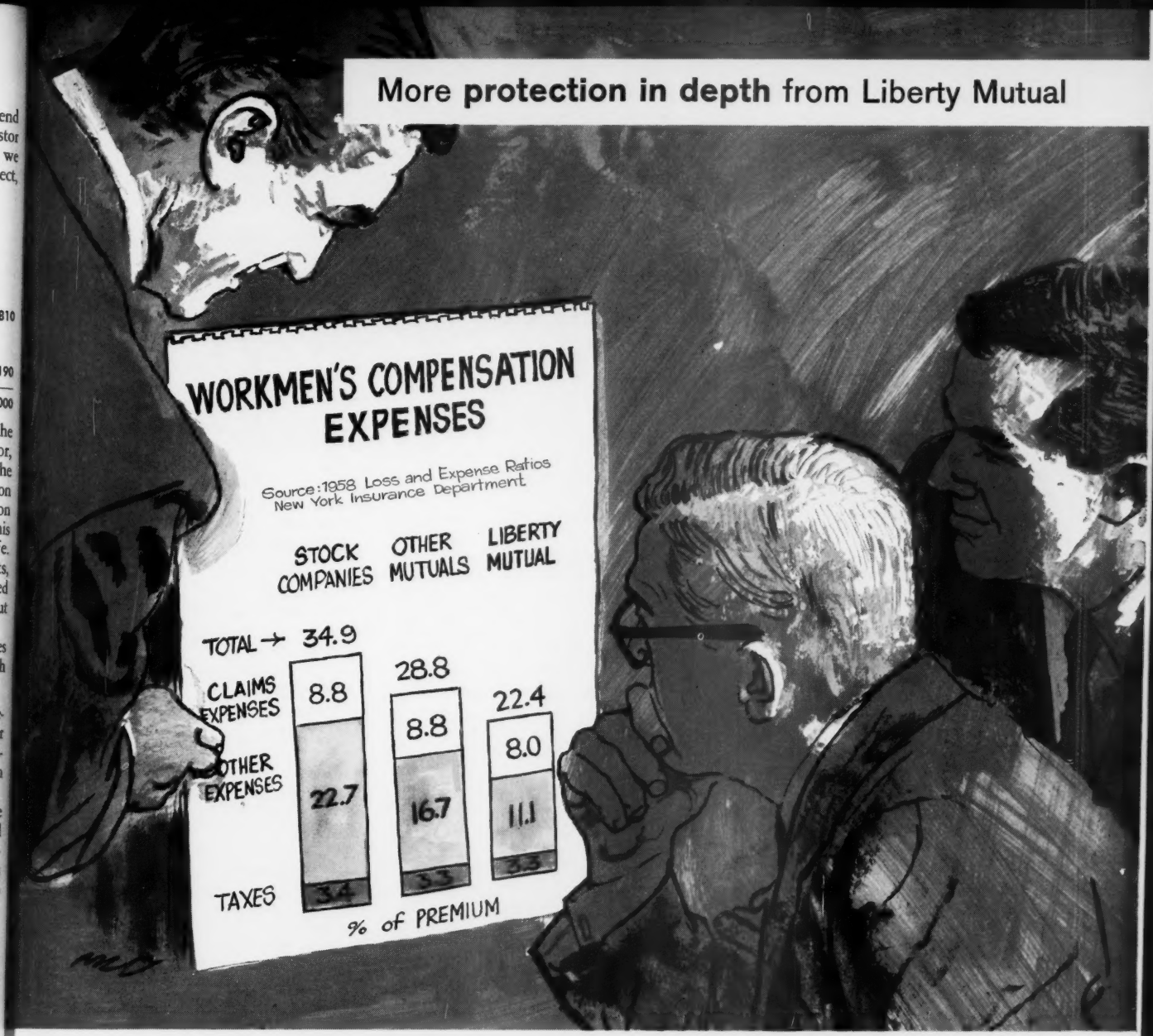

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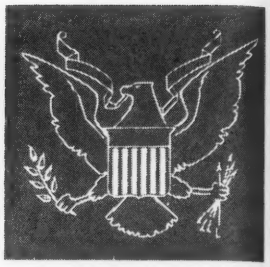
ISSUES AT THE HEART OF

The 1961 Federal Budget

John A. Beckett



With the fiscal year of 1960 having five months to run, it appears that outlays by the Federal Government for the year will be about $78.4 billion. This means that a surplus of slightly more than $200 million will be attained. Taking up key components of the 1961 federal budget one by one, the assistant director of the Bureau of the Budget explains why and how a substantially greater surplus will be sought for the fiscal year beginning next July 1.

IN THE PAST SIX MONTHS all the agencies of the Federal Government have been busy putting down their 1961 financial needs as they see them, and screening them through the Bureau of the Budget in the Executive Office of the President. The President himself has spent many hours and days reviewing the proposals and resolving the major issues which always arise in preparing the new fiscal year's budget.

That new financial plan—the budget for 1961—was presented to the Congress, accompanied by the President's budget message and his recommendations, at the start of the Second Session of the 86th Congress on January 18.

Most of the readers of these pages know the dimensions of that budget; they have seen them emblazoned across the headlines of the American press. They know that the President has proposed a budget which contemplates an excess of revenues over expenditures in fiscal 1961 of $4.2 billion. They may even know that this budgetary surplus would be the second largest in the fiscal history of the United States. And they certainly know that this is good news.

But they may not be familiar with a number of the *issues* which are presented by the 1961 budget. It is with the objective of identifying some of those issues that this article has been prepared.

JOHN A. BECKETT, assistant director of the Bureau of the Budget, Washington, D. C., graduated from the University of Oregon in 1938 and received an M.B.A. degree from the Harvard Graduate School of Business Administration in 1943. A CPA in Washington, Massachusetts and Illinois, he was formerly midwestern regional director of the business consulting activities of Arthur Young & Company, Chicago, Ill.; served as fiscal officer in the Army Transportation Corps in World War II; and was on the faculty of the Alfred P. Sloan School of Industrial Management at MIT.

THE SETTING OF THE BUDGET

It is expected that the period from mid-1960 to mid-1961 will be a prosperous one. That fact is basic in planning federal finances for fiscal 1961. It has influenced the Executive Branch in its preparation of the proposed budget, and it will undoubtedly influence the Congress in its treatment of the budget as a whole and of its parts.

How it will influence the Congress and the people of the United States is another thing. A budgetary surplus could be taken to mean that we can now "afford" some of the things which many people would like to see the Federal Government pay for. There is, however, very good reason for quite the contrary view. The time when you have the money can, in personal and federal finance, be the time when some payments are made to reduce the size of the mortgage which resulted from past deficits and borrowings. This latter course of action is the one the President proposes.

The recent history of U. S. Government finance shows marked increases of government expenditures in times of economic recession, as well as in times of war; our "reasons" for enlarged spending at such times are now strongly urged and indeed seem to be part of the unfolding tradition of the new "economics."

If we manage to find the rationale for increased government spending in good times on the premise that we can now afford to spend more, then we will have succeeded in providing the final reason why high levels of government spending are desirable at *all* times.

The fact that the year ahead appears to be a good one—one in which government revenues will increase—does not by itself justify the wholesale commencement of new programs involving increased spending by the Federal Government no matter how desirable they may seem. New spending programs must be viewed in the light of their fiscal consequences when taken

together with the built-in growth features of other government programs.

The fact is that many government programs are due to cost much more in the future than they do at present—as we shall see. Unless the income of the Federal Government increases along with the expenditures, further deficits will be suffered and the debt of the Government will rise.

With the present debt of the Government standing at $290 billion and costing $9.5 billion in carrying costs each year, might it not seem that the first place to apply the surplus—after providing for starting of carefully selected new projects—would be to the reduction of the federal debt?

This is what the President has proposed to the Congress—that only after some sizable payments have been made against our national mortgage can significant tax reduction or substantial new federal programs be undertaken. *This is the first issue of the 1961 budget.*

THE BUDGET ITSELF

Actually the proposed budget for 1961 contemplates expenditures at about $79.8 billion—$1.4 billion larger than fiscal 1960 but $1 billion less than the recession-induced spending of fiscal 1959. Revenues will be at an all-time high of $84 billion—the product of the high level of economic activity which we expect.

Let's see what the $79.8 consists of, and what other issues are disclosed by a careful look at the 1961 budget.

If you will study the table of budget expenditures, you will see that in fiscal 1961 there will be an increase in the cost of programs of the Federal Government in all but two functional classifications (major national security and commerce and housing), as compared with fiscal 1960. This is indicative of the trend of government costs; the pressures for continually higher levels of government spending persist in spite of the most zealous and persistent efforts to hold them down, as will be shown in some examples in later paragraphs.

But the trend, in turn, is only a symptom of other causes. When we look at some of those causes, we will expose *other vital issues* presented to the American people in the 1961 budget.

1. Defense. Few of us need to be reminded of the complexity of the issues surrounding the problems of defending our Nation and helping to preserve the principles of freedom and democracy throughout the world. For one thing the pace of change is so great that it imposes harsh problems on the processes of planning for military preparedness.

The costs of maintaining and operating an increasingly large physical plant and the personnel to run it lay a heavy hand on the military budget. At the same time new military concepts and high obsolescence hardware are increasingly costly and require a degree of flexibility never before known in military history. The competition between these two forces presents one of the most difficult problems in military planning. There are almost unlimited demands for financial support for each of them.

Another problem is that of the extent to which we can and should assist our sister nations of the free world in providing adequate military protection for all free nations. We cannot relax our efforts to help strengthen the military effectiveness of our allies. This is essential to the security of the free world.

The major issue in this part of the budget is: *Is the budget for defense and military assistance large enough?* The President is emphatic in his answer. In his Budget Message to the Congress he said:

> Our aim at this time is a level of military strength which, together with that of our allies, is sufficient to deter wars, large or small, while we strive to find a way to reduce the threat of war. *This budget, in my judgment, does that.*

2. International Affairs and Finance. The international activities of the Nation, as reflected in our country's programs to maintain world peace and improve economic conditions throughout the free world will cost more in 1961 than they did in 1960, mainly because of larger disbursements by the Development Loan Fund under prior commitments. By fiscal year 1961 that Fund will have made commitments for some $1.4 billion for loans, more than three-fourths of which are for roads, railroads, electric power generation, and industry including industrial development banks, in less-well-developed countries. Because many of the projects which are the subject of loans from the Fund are of such a nature that they require several years for construction, expenditures thus far have been relatively small. In 1961 the Federal Treasury will begin to feel the momentum of such program development.

Clearly, the institution of such substantial, long-term, and far-reaching programs carries with it future budgetary commitments of a sobering nature.

This is a continuing fact of our federal budgeting process—and one which is becoming more widely recognized by the American public. The President does not start from a zero base when he sets about drawing up the Nation's budget each year. Commitments of the past—most of them for most worthy and timely pur-

RESUME OF THE BUDGET

(Fiscal years. In billions)

	1955 Actual	*1956 Actual*	*1957 Actual*	*1958 Actual*	*1959 Actual*	*1960 Estimate*	*1961 Estimate*
Budget receipts	$50.4	$68.2	$71.0	$69.1	$68.3	$78.6	$84.0[1]
Budget expenditures	64.6	66.5	69.4	71.9	80.7	78.4[1]	79.8[1]
Budget surplus (+) or deficit (—)	—4.2	+1.6	+1.6	—2.8	—12.4	+.2	+4.2

[1] Includes amounts for proposed legislation.

BUDGET EXPENDITURES

(Fiscal years. In millions)

Function	*1959 Actual*	*1960 Estimate*	*1961 Estimate*	*1961 Per Cent of Total*
Major national security	$46,426	$45,650	$45,568	57.1
International affairs and finance	3,780	2,066	2,242	2.8
Commerce and housing	3,421	3,002	2,709	3.4
Agriculture and agricultural resources	6,529	5,113	5,623	7.0
Natural resources	1,669	1,735	1,938	2.4
Labor and welfare	4,421	4,441	4,569	5.7
Veterans' services and benefits	5,174	5,157	5,471	6.9
Interest	7,671	9,385	9,585	12.0
General government	1,606	1,711	1,911	2.4
Allowance for contingencies		75	200	.3
Total	$80,697	$78,383	$79,816	100.0

poses—dictate a large part of the contents of each year's budget. The control of the President over the budget for any one year is greatly circumscribed.

But the *basic issue* is whether this Nation is willing to help the underdeveloped areas of the world achieve a degree of economic advancement which will provide hope to the peoples of these areas. Our own security in the world requires the continued confidence of these peoples in their ability to improve their lot as members of the free world society. Many of these areas are newly independent or are about to achieve independence. In all of them there is an increasing demand on the part of the peoples for economic betterment.

3. Commerce and Housing. In commerce and housing the expenditures budgeted for 1961 will decline by almost $300 million—*net, that is*—if the Congress accepts the recommendation of the President that postal rates be increased and taxes be levied on fuels for jet aircraft.

Here the significant issue is *the principle of requiring the beneficiary, rather than the public in general, to pay the costs of certain government services.* The President has consistently espoused this principle with respect to government services which benefit certain groups—in these cases the users of the mails and the airlines.

But the fact of increasing costs of government programs is reiterated here; unless postal rates are increased to offset the traditional and rising postal deficit, the net costs to the general taxpayer of commerce and housing programs will surely rise in 1961.

It might be noted here that the postal deficit today is not the same kind of postal deficit the Nation endured in earlier years. The Post Office Department has introduced more modern machinery and methods and is planning substantial further improvements toward more efficient mail-handling. But the volume of mail handled has vastly increased in recent years, and thus the total cost of the activity is on the rise and far exceeds revenues at present postal rates.

4. Agriculture. A look at the agriculture function in the budget discloses still other issues, in addition to those which are common to almost all others—rising expenditures and very little opportunity for presidential control over current program.

The biggest single problem in the budget for agriculture is *wheat.* By the middle of this year we will have wheat stocks equivalent to about two years' domestic supply—the highest on record. This is a product of outmoded production control laws and the incentives which come from high price supports.

In his State of the Union Message, the President said:

> Our basic farm laws were written 27 years ago, in an emergency effort to redress hardship caused by a worldwide depression. They were continued—and their economic distortions intensified—during World War II in order to provide incentives for production of food needed to sustain a war-torn world.
>
> Today our farm problem is totally different. It is that of effectively adjusting to the changes caused by a scientific revolution. When the original farm laws were written, an hour's farm labor produced only one fourth as much wheat as at present. Farm legislation is woefully out of date, ineffective, and expensive.
>
> In order to compete in the world wheat markets without continued substantial subsidies from the Federal Treasury, and in order to encourage the making of meaningful adjustments in over-all farm production, we must take some steps to permit the laws of supply and demand to begin again to work in the market place for wheat and to free the farmer from undue controls.
>
> In the 1961 budget the President proposes that acreage controls on wheat be removed and that price supports be related to average market price over a base period of the last three years.

The *issue* here is whether it does indeed serve the best purposes of our Nation and, in fact, the world to continue to pile up surplus stocks and pay carrying costs which, for all commodities, now amount to well over $1 billion a year.

5. Natural Resources. Expenditures for natural resources in 1961 will be up by about $150 million—to $1.9 billion—the largest amount ever spent for this purpose. The size of this budget reflects a recognition of the great importance of natural resources to the Nation's economic growth.

Here again the increase is due largely to commitments made when projects were started in earlier years; only a small proportion is attributable to the 42 new projects which will be started in 1961.

Most of the increase is for water resources development and, as most of us know, the future water supply of our Nation is a matter of sobering significance. It involves *issues* of international agreements, federal-state relationships, flood control, cost sharing, conservation, and research for converting sea water and brackish water into fresh water, to mention a few.

The President has again recommended that legislation be enacted to require that identifiable nonfederal interests which receive flood protection benefits bear at least 30% of these costs. This is a *major policy issue* in the financing of water resource projects.

6. Labor and Welfare. Budget expenditures for labor and welfare activities, already at a record level, will increase in 1961 by $128 million. They will total $4.6 billion, more than double the amount a decade ago. If social security and other payments from trust accounts are counted, expenditures for labor and welfare activities in 1961 will total more than $20 billion, three and one half times the level 10 years earlier.

In the 1961 budget message the President said:

> Our Nation seeks to foster a climate of freedom and creativity in which education, the arts, and fundamental science can flourish. The Federal Government helps in the attainment of these objectives through programs for support of basic research, and to educational institutions, and training assistance to individuals in various fields important to the national interest.

He recommended increased appropriations for high-priority education, and research programs and enactment of new legislation to authorize additional aids to education.

We all know that there is much to be done in our country in furthering the cause of science, of health, of education, of welfare, and the many other programs which enter into the vast expenditures in the labor and welfare field. The rapid re-

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cent growth of these programs and the numerous proposals for their further expansion, however, raise a basic issue of national policy.

We sense that there is a substantial question as to the portion of the responsibility which should rest on the shoulders of the Federal Government.

This question arises when we consider that expenditures by the National Institutes of Health for grants and direct support of medical research have multiplied manyfold in the last decade, while at the same time federal funds have increased sharply to more than half of our national health research outlays. It is a basic issue in the public assistance field, where the federal share has risen from 44 per cent in 1946 to 58 per cent in 1961 while federal expenditures have quintupled to a total of $2.1 billion. It also comes to the fore every time the Federal Government significantly increases its aid for education, which has traditionally been a local, state, and private responsibility.

President Eisenhower has spoken out many times on this major issue concerning the intrusion of the Federal Government into fields which should more properly be carried out by private or by state and local units. In his address to the 1957 Governors' Conference at Williamsburg, Virginia, he highlighted the principle drawn from the struggle of the colonists:

> . . . those who would be and would stay free must stand eternal watch against excessive concentration of power in government.

Subsequently in the annual Budget Message to the Congress in January 1958, the President stated:

> . . . the continued vitality of our federal form of government requires that, to the maximum extent possible, primary responsibility for public programs be shouldered by that level of government most familiar with local problems and most responsive to them. We must exercise the utmost restraint in assigning new programs and responsibilities to the Federal Government, and we should continuously search out those programs and activities now carried on at the national level that can and should be handled by the states or localities.

7. Veterans' Services and Benefits. Veterans' benefits, like most other categories of federal expenditures, are also growing. In 1961 they will increase $314 million to a total of $5.5 billion, comprising almost seven per cent of the federal budget. This increase was caused by additional pension cases and higher pension rates, both authorized by the Veterans' Pension Act of 1959.

This country has not stinted in providing for its veterans and their dependents. The special veterans' benefits laws which the Congress has enacted are the most generous in the world. It has been estimated that under existing laws World War I, World War II, and Korean conflict veterans and their survivors will receive in the years to come benefits or services costing $300 billion—a total greater than our present federal debt.

Some of these expenditures are highly meritorious. Others, however, raise major policy issues—pensions which are paid for causes not related to service, for example, originated after the Revolutionary War to provide relief to needy veterans. Today, however, we have a comprehensive social security program which insures 85 per cent of all our labor force, and an additional eight per cent of the workers are covered by other public retirement programs. Despite this, the veterans' pension program has been continued, and even liberalized. Thus, a considerable proportion of our population will receive simultaneous old-age benefits from two sets of programs.

In his Budget Message, the President recognized this issue by saying:

> In addition to the special veterans' programs, a great majority of veterans participate in the general social security, health, and welfare programs which are financed wholly or in part by the Federal Government. In the future these general programs will provide with increasing adequacy for the economic security needs of our elderly population, of which veterans and their widows will constitute a large and increasing proportion for several decades.

Holding the cost of these programs to a sensible level can only be done if the electorate understands these problems and makes known its desire for change.

"Here's an author with an inventive mind—
the husband is taking the wife out to dinner"

8. Interest. The federal debt now stands around $290 billion and the annual interest cost is around $9.4 billion—12 per cent of our budget expenditures. In 1961 it is expected to be about $200 million higher.

Much of this increase is attributable to the rental rates for money, which are higher at present than they have been at any time since the early 20's.

One issue here is whether or not to remove the 4¼ per cent interest limitation on long-term government bonds.

Under present law the Treasury cannot pay more than 4¼ per cent on government bonds. Yet the going rate for money is higher than 4¼ per cent for maturities of five years and over. Hence the Treasury is unable to borrow with long-term obligations, and is forced to issue shorter-term issues exclusively.

The first effect of this is to make more difficult an orderly management of the public debt; a larger and larger proportion of the total debt of the Government tends to become of the short-term variety, requiring the Treasury to refinance substantial amounts at frequent intervals.

A second effect of the ceiling is that the interest costs of the Government are increased, since the Government's needs compete with the demands of business and the public for borrowed short-term money and tend to drive up rates to the point that at times the interest rate on short-

(Continued on page 92)

The Accountant's Interpretive Job

HOW FAR SHOULD IT GO?

Charles H. Griffin

Could the accountant's internal reporting to management be enhanced by greater use of statistical analysis and projection?

FINANCIAL REPORTS of recent date, with their plethora of charts, diagrams, and other illustrations, make it plain that the accountant is giving much attention today to interpretation. Indeed, the current emphasis on managerial advisory service —called by some, the accountant's new frontier—seems to embrace the interpretive role of the accountant as important to the logical conclusion of this activity.

How far should the accountant's interpretive role extend?

Historically, it has usually been carried out by undertaking after-the-fact analyses of observable changes in the accounts, in which conventional analytical devices have produced significant rewards. However, accountants have also indulged in before-the-fact forecasting, planning and programming. Through this, an attempt is made to foretell the accounting consequences and financial implications of proposed new courses of action.

Are both these practices—one historical analysis, the other projective interpretation—consistent with the dimensions of the accountant's interpretive role?

Are there yet other areas in which the accountant has the capacity for fruitful interpretive service, and what are his responsibilities in this connection?

DATA IMPORTANT TO DECISION-MAKING

Accounting analysis—whatever its form —is directed toward providing information important to the formulation of reliable judgments. Whether it be a critical examination of causal conditions or a projective interpretation based thereon, the analysis presumes availability of data that are sufficient, timely, and relevant for decision-making. The sources of these data are numerous. The accounting records, the primary concern of the accountant, abound with useful information; yet, the translation of these data into managerial decisions often implies the collateral use of other cogent financial and economic data.

Many cases might be cited wherein accounting records alone have proved insufficient to support the taking of managerial action or to provoke a change in existing policy. For example, the income tax consequences of proposed courses of action remain a compelling influence in electing what otherwise might appear to be equally desirable alternatives. Additionally, consideration of the time value of money subtends very nearly the whole arc of management decision-making. The investment of funds for a specific purpose necessarily implies a lost opportunity for other investments, with their promise of interest or other reward.

Even in the analysis of data extracted from the accounts, one must be wary of drawing inferences of greater precision than the accounting system would seem to justify. Most accounting methodology in its preoccupation with cost collection, classification, and allocation makes frequent use of estimates and approximations. Such use implies the acceptance of a permissive range of error. Furthermore, while a system contrived to provide the greatest possible quantity of accounting data may be impressive in its detail, it may be singularly deficient as a managerial aid.

HISTORICAL ANALYSES

The compilation of data completed, their significance must be measured. The accountant's responsibility as analyst requires that he elicit the meanings and implications of these facts. Traditionally, he has approached this task by seeking to determine the causes of changes in account balances and to measure the changes in relationships between account categories.

One of the earliest signs of interpretive progress was the introduction of comparative data into the financial statements. The presentation of accounting data in adjacent columns for a number of successive time periods has enabled the reader to note quickly the directional movement in the account balances. This type of analysis has been enlarged to include additional columns for amounts and percentages of change. Such a format, while an improvement over the older forms, does not, however, identify the forces responsible for variations nor measure their relative magnitude.

Responding to the need for explanation of causal factors, accountants have often appended useful supplementary schedules to their formal statements. These include statements of receipts and disbursements, sources and applications of funds, anal-

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yses of variations in profit, and numerous others. Much useful information has also been obtained by measuring variations in the relationship of account categories *within* the statements. In this connection, it is observed that the analyses have usually assumed a vertical posture, with various account classifications measured relative to others. Ratio and percentage analyses have been the techniques most frequently employed in this application. Some of their uses include the evaluation of current position, asset distribution, asset mobility, relative position of the equities, relationship of owner and creditor interests in assets, and a variety of other significant relationships.

Vertical analyses also embrace such determinations as book value per share of stock, dividend rates, earnings per share, and the equity class interests in earnings. The vertical format has also been usefully extended to percentage analyses, wherein various account classifications are expressed as percentages of a base measurement. These statements of percentages, more recently referred to as *common size statements,* have proved particularly useful in their comparative application to those of other businesses as well as to industry standards. These techniques of vertical and horizontal analyses should not be regarded as mutually exclusive analytical mechanisms; their benefits are compounded by their reciprocal indebtedness. Together with other important determinations, they have measurably improved the value of the accountant's internal reports to management.

PROJECTIVE INTERPRETATION

Despite the acknowledged worth of these analytical measurements, they require interpretation in the light of other influences. It is hardly necessary to say that the ultimate responsibility for the formulation of business policy and the making of decisions remains a managerial prerogative. Yet, there is also little doubt that the accountant in his data collecting and analyzing processes has acquired knowledge sufficient to justify his position as adviser. This role is often conceded by management. Some may conclude that because of his unusual familiarity with much of the data requisite for decision-making, the accountant is especially well fortified to engage in useful financial projections. Yet, it must be recognized that many of the influences important in the deliberative processes of management do not fall within the purview of his primary responsibility and concerning which he may have little knowledge. To the extent that such external influences assume the more prominent role in decision-making, the value of the accountant's projective contribution would appear to be reduced.

In truth, reliable business projections require the use of methods derived from both the accounting and statistics disciplines. The accountant has long accepted the statistical mechanism for data collection; however, he has hesitated in the use of statistical analysis. However, current forays into the field of management consultation by other professional groups emphatically focus attention upon the possibilities for increased statistical application in the solution of management's problems. Refinements in existing instruments of measurement, as well as new developments, dramatize this opportunity.

The statistics discipline enlarges the possibility for understanding the forces responsible for the behavioristic patterns of business. Through the use of the mechanism of time series analysis, the effects of seasonality, secular trend, cyclical rhythms, and irregular or erratic movements can be identified and measured. Also, through the use of index numbers, accounting data reflecting variations in monetary value may be deflated and thereafter profitably used in comparative and other studies.

Perhaps the hesitancy of accountants to utilize statistical analysis—particularly its projective potential—may be attributed to a peripheral reaction to a basic conviction of many accountants—that only those data should be recorded in the accounts which are objectively determined and supported by verifiable evidence. Nonetheless, accountants frequently have indicated a willingness to engage in accounting and financial prophecy so long as their projections are not reflected in the actual accounts. Evidence of this indulgence is to be found in their participation in the preparation of budgets, financial plans, and other types of anticipations. The excellence of their contribution in these areas hints at the value which might possibly be adduced from extending the application of statistical analysis and projection to other forms of internal reports.

The mutual dependence of accounting and statistics is generally acknowledged. The importance of statistics is given curricular support by most colleges, which require completion of courses in statistical method for baccalaureate degrees in business. In consequence, one may infer that the graduate in business does have a basic understanding of these tools and the benefits accruing from their application.

R. M. Trueblood, a frequent and authoritative spokesman for both statistics and accounting, invites their cooperation that the rewards of their mutual support may be achieved. "The entire problem of adapting statistical methodology to accounting and management controls still lies largely ahead. To attack and satisfactorily resolve a problem of these dimensions will involve creative use of the resources of both the accounting and statistical professions. In part, the attack will have to come at the level of fundamental research. Partly, the attack will be directed piecemeal at the level of practical expediency. It is well, therefore, to recognize the limitations as well as resources of both disciplines. Accountants are not going to establish statistical techniques.

(Continued on next page)

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Statisticians are not going to solve management control problems. Collaborative efforts between the two disciplines will be required." (R. M. Trueblood and R. M. Cyert, *Sampling Techniques in Accounting,* Prentice-Hall, Inc., Englewood Cliffs, N. J., 1957, p. 81.)

COMMUNICATION OF INTERPRETED DATA

An additional consideration in measuring the scope of interpretation in internal reporting concerns the effectiveness of communication. The fulfillment of the reporting function presumes the use of those methods of communication which will lucidly and quickly convey the significance of the interpreted data. To this end, the accountant is importuned to use those methods of description—whether by graphic or tabular presentation, a counting schedules, or narrative explanation—which are most easily understood by the reader.

"Not infrequently the communicative efforts of the accountant, like those of other professional people, are punctuated by well-worn words and phrases that mean little or nothing to the laymen; and, upon analysis, quite surprisingly he finds that they mean very little to himself. Perhaps they seem to be justified by precedent and to carry with them a suggestion of authority or finality; perhaps, in some situations, as one sardonic member of the profession has noted, polysyllabic sonority confers no end of dignity and conviction on an otherwise arid report." This observation by Eric Kohler bespeaks the pitfalls implicit in the use of an inherited professional jargon. (E. L. Kohler, *A Dictionary for Accountants,* Second Edition, Prentice-Hall, Inc., Englewood Cliffs, N. J., 1957, p. vii.)

CONCLUSIONS

The author does not take a position as to what are, or should be, the appropriate dimensions of the accountant's interpretive function in internal reporting. He merely poses the question as to the possible value to be adduced from establishing definitive limits for this responsibility. Definitions of *accounting* often provide succinct descriptions of the nature of the accountant's work, but they give little directional guidance in the determination of useful limits for accounting interpretation. The accountant has derived benefit from and has been directed by an orthodox methodology in his recording processes; he has been guided helpfully by regulatory agencies, professional societies, and established conventions in his reporting function. However, he has been given comparatively little aid in determining the extent of his responsibility to management in interpretive internal reporting. Measurable benefit might well accrue from a delimitation of the scope of this important function.

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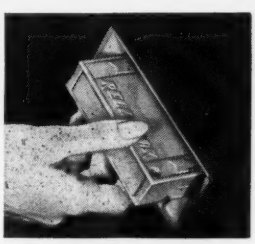

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Business Encourages Participation in Politics

AMERICAN COMPANIES, acting through their executives and other employes, should take an active part in the political and governmental process, in the opinion of a majority of 198 manufacturing executives participating in a National Industrial Conference Board survey.

The extent of participation advocated and practiced by these executives' companies ranges all the way from group activities through such organizations as trade associations to merely encouraging employes to get out and vote. Nearly all favor the latter course, and many also urge their employes to give financial support to the party of their choice.

Reasons most frequently advanced to explain their companies' participation in politics include:

It is part of a company's "responsibility of citizenship."

The welfare of most companies is very dependent on the actions of federal, state and local governments.

Unless industry becomes active in politics, it will be at the mercy of legislative bodies controlled by aggressive minorities that lack sympathy or concern for the problems of industry.

On the other hand, a significant minority of the executives participating in the survey believe that the corporation as such cannot and should not take any position or active part in the political process. Some of these respondents fear that their efforts would prove to be ineffective or even harmful because they lack political skill and finesse. Other companies are hesitant to become active for fear they might be misunderstood by their employes.

Almost all respondents are in favor of their top executives actively participating in the political process as individuals. These cooperators reason that there are many areas in government where sound business thinking is critically needed for the well-being of the Nation and believe it is up to qualified businessmen to step in to supply it.

Most feel, however, that the demands made on the time of top executives by the business affairs of their companies usually make it impossible for such executives to also play effective political roles.

Cooperating companies are also almost unanimously in favor of encouraging employes other than top executives to take an active part in the political parties of their choosing, although they stress that this must be done on a nonpartisan basis. Among the means used to stimulate interest are company support for "register and vote" campaigns, and educational programs to encourage political participation. Some of these education programs are set up by the company and some by outside sources, but they are usually run on company premises and attendance is entirely voluntary.

While most companies try to remain nonpartisan in the stimulation of employes, a few recommend candidates to their employes and give reasons for their selection. Others publicize the voting records of legislators to their employes.

Most of the cooperating companies are willing to give employes a reasonable amount of time off to carry through on the political programs for which they have volunteered. In fact, the Conference Board finds respondents are more apt to encourage middle management and rank-and-file employes to accept such responsibilities than top executives because top executives are, as one cooperator states, "already overburdened with a host of other duties and activities."

Companies should keep their employes posted on proposed or pending legislation that will have an effect on the company or on business in general, according to all but four of the 180 firms responding on this point. However, few companies attempt to keep their employes informed on all other legislative issues because they feel there are too many of them and that to do so would prove confusing to the average worker.

One group of companies made a careful study of the legal ramifications, and their findings indicate that the sphere of activity available to corporations is much larger than generally realized. However, despite any latitude available, most companies seem to favor the avoidance of partisan activity.

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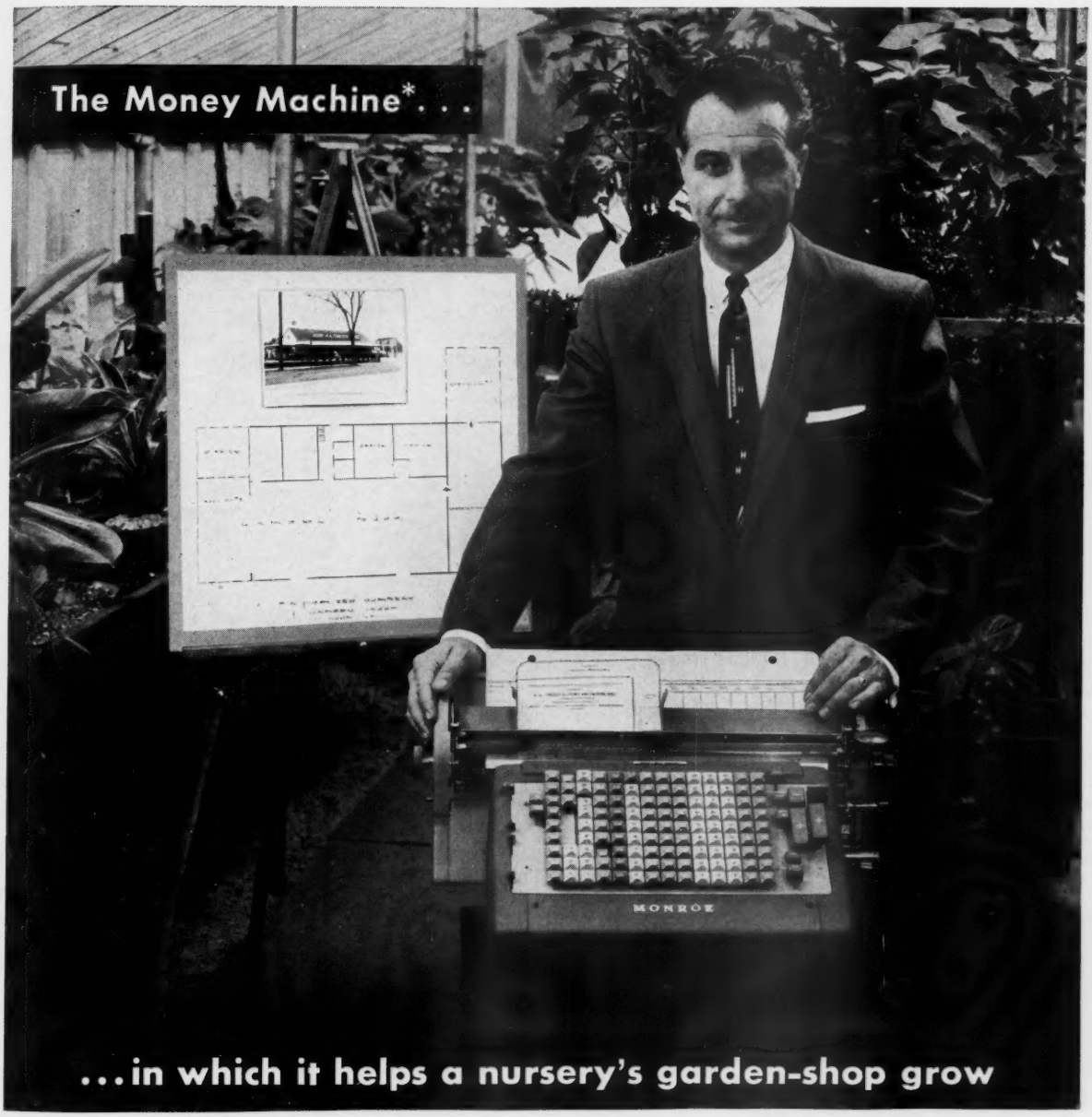

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Paging the New Books

FEDERAL TAX ASPECTS OF ASSOCIATION ACTIVITIES*

By George D. Webster

Reviewed by WM. J. RITTER
CPA, New York

A question that is raised in the minds of accountants, attorneys and executives with regard to trade associations and other organizations exempt under IRC section 501 is:

What pitfalls must be avoided to prevent the loss of tax exemption or avoid taxation of certain transactions as doing business in connection with the association activities?

The author of this book has presented a very palatable analysis of the basic requirements to obtain and retain tax exemption.

Obviously due to the variety of organizations granted exemption, there can be no set rules promulgated that would be applicable to all concerned. The author in recognizing this fact presents the various facets of the applicable code sections by referring to prior court decisions and current IRS regulations and emphasizing that there are several conflicting decisions making the road a more precarious one to travel.

The book should be studied by everyone interested in association management —both staff and elected officials—bearing in mind that the regulations should be examined annually for new rulings affecting a particular group.

** Published by the Chamber of Commerce of the United States, Washington 6, D. C. $4.50.*

DEVELOPING A PRODUCT STRATEGY*

The over-all management responsibility for product planning and development was the basis for the special conference of February 1959, sponsored by AMA's Research and Development Division, from which most of this book is drawn. To further emphasize the need for an organized, rounded approach, papers have been added from earlier AMA reports highlighting the contributions made by top management, the controller's office, research personnel, engineering and production, and the sales organization.

Following a general introduction, the book is divided into six parts, each with its own introduction: Planning and Organization; Research and Exploration; the Product-Screening Process; From Engineering to Production; Marketing Plans and Procedures; and Financial Requirements.

** Published by The American Management Association, 1515 Broadway, New York 36, N. Y. $7.50.*

CREDIT MANUAL OF COMMERCIAL LAWS, 1960 EDITION*

For the 52nd year, this one-volume reference work for executives is being issued in revised annual form by the National Association of Credit Management. Among important federal changes covered in the new volume are six amendments to the Federal Bankruptcy Law, a law to counteract the effect of a U. S. Supreme Court decision that a state may tax the net income from interstate operations of an outside-the-state corporation, and a statute extending the Renegotiation Act to June 30, 1962.

With 47 state legislatures in session during the past year, the number of new state laws and changes affecting credit operation was substantial. The opening chapter of this book summarizes their application to such fields as sales and use taxes, secured transactions, assignment of accounts receivable factors' liens, mechanic's liens, bad check laws, claims against estates and so on.

New features of the 1960 Manual include a summarization of 1959 state instalment sales laws and a section on definitions of less-technical words and phrases used in automation.

** Published by the National Association of Credit Management, 229 Park Avenue South, New York 3, N. Y. $12.00.*

The Preparation of the Annual Report: A Document of Modern Business*

Over 75,000 annual, quarterly and interim reports were reviewed and classified in compiling the material for this book. The information contained in this volume covers such areas as cover design, executive messages, scope of operation, financial narratives, charts, graphs, all types of art, photography, envelopes, paper stock, transmittal forms, and methods of printing. It also includes editorial matter and surveys concerning budgets, responsibility for the preparation of such reports, and distribution.

** Published by Research Bureaus, Inc., Box 68, Kensington Station, Detroit, Mich. $15.00.*

The Appraisal of Capital Expenditure*

By C. G. Edge

In this comprehensive brochure, the author deals with the major measuring devices employed in capital evaluation today. He includes suggested administrative procedures for approving appropriation requests as well as examples demonstrating the method of computing results using compound interest formulae. Also discussed are such newer methods of appraisal as the discounted cash flow, the present worth method, or the investors' method.

** Published by the Society of Industrial & Cost Accountants of Canada, 31 Walnut St. South, Hamilton, Ontario, Canada. $3.00.*

Ordinary and Necessary Expenses*

By William K. Carson and Herbert Weiner

This book provides practical guidance on the tax problem of identifying those expenses which can be properly considered "ordinary and necessary" and therefore deductible under the law. Significant cases representing each of the various types of expenses are arranged and analyzed according to their situations and the findings of the courts. Key factors are discussed both for the purpose of tax-planning action and substantiation of expense deductions already claimed.

** Published by the Ronald Press Company, 15 East 26th Street, New York 10, N. Y. $10.00.*

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Depreciation and Taxes*

The many-faceted problem of the tax treatment of depreciation is discussed from the points of view of the various tax-oriented professions in this symposium volume. Fundamentals of depreciation policy are outlined in Part One with a summary of the purposes and functions of depreciation under the income tax; the impact of depreciation as an element in investment decisions; and General Foods Corporation's experiences under the 1954 revenue act and management's responsibility for depreciation policy.

Part Two is devoted to a consideration of depreciation and the changing price level, and includes discussions of the fundamental economic issues; phantom profits as seen by an accountant; specific problems of utilities; and the question of management responsibility and inflation. Specific aspects of tax policy and management decisions are discussed in Part Three, with an examination of the relationship between realistic depreciation and compensation policies; Internal Revenue policy on depreciation; problems of Internal Revenue Service administration; and the relation of depreciation to capital gains.

Part Four is concerned with considerations in depreciation reform, and includes an outline of depreciation practices in foreign countries; proposals for depreciation reform; and views on the establishment of priorities in tax reform.

** Published by the Tax Institute, Inc., 457 Nassau Street, Princeton, N. J. $6.00.*

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Cash and Due from Banks	$ 96,855,662.11
Securities—U.S. Government and its Agencies	97,555,758.45
Securities—State and Municipal	46,692,656.17
Other Bonds and Investments	12,831,742.94
Loans and Discounts	153,070,939.03
Real Estate Loans—Insured or Guaranteed	43,989,671.50
Banking Houses—Furniture and Fixtures	4,237,422.85
Accrued Interest and Other Resources	2,490,593.88
	$457,724,446.93

LIABILITIES AND CAPITAL

Capital ($12.50 par value)		$ 7,000,000.00
Surplus		20,000,000.00
Profits		3,513,498.86
Reserve for Taxes, Interest, etc.		2,344,526.71
Reserve for Dividend		406,000.00
Unearned Discount and Other Liabilities		7,802,889.81
Deposits—		
Demand	$330,705,995.92	
Time	85,951,535.63	416,657,531.55
		$457,724,446.93

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The Management Looks at Profitability Measurements

(Continued from page 62)

bility of the manager, because time is one of the factors directly affecting profitability. The importance of this responsibility becomes even more evident, as we shall see, when the manager wishes to measure a project's profitability for only a portion of its life.

Use Taxes as Booked. If the depreciation contour the manager chooses is the same as the depreciation method used, either for the firm's usual accounting depreciation or for the firm's tax determination, the income tax amount in the study obviously should be the incremental amount that will be shown on the income statement. But in a case where the depreciation contour selected for the study is different from either of these, a question arises as to what depreciation contour should be used for determining the tax.

The manager has a free choice as to the depreciation contour he selects for the study. He has no such choice when it comes to income taxes. They represent a real expense associated with the project, just as maintenance or other expenses. Therefore, the taxes shown in the study should be those payable, regardless of the depreciation contour chosen. The taxes payable will be based on the depreciation contour used for the firm's tax determination, no matter what contour is selected for the profitability study.

An Example. Let us suppose that we have at hand the best available estimates of the initial capital outlay required for a project together with the incremental revenues, taxes and expenses (other than depreciation) for each year. For comparative purposes let us first compute the return, using the discounted cash flow method.

TABLE G
Discounted Cash Flow Profitability
Total initial capital required for project—$10,000
Estimated life—10 years
Salvage value 10 years hence—0

Year	(1) Cash Flow (after tax, before depr.)	(2) Discount Factor at 39%	(3) Present Value of Cash Flow at 39% (1) × (2)
1	$8,000	.719	$ 5,752
2	4,000	.518	2,072
3	2,800	.372	1,042
4	1,800	.268	482
5	1,600	.193	309
6	1,000	.139	139
7	900	.100	90
8	800	.072	58
9	700	.052	36
10	600	.037	23
		Total	$10,003

As noted earlier, the particular discount rate which will produce a total present value equal to the original outlay has to be determined by trial and error. Once determined this is the measure of profitability for this project. We would tell the investor, theoretically, that for this project he is investing his funds at a profitability rate of 39 per cent.

Before we can restate this example using the composite earnings-yield method, the manager has to make two decisions: (1) The depreciation contour to be used and (2) the rate of earnings to be assumed for the depreciation reserve. Let us assume that the manager has indicated that straight-line depreciation is appropriate for this project and that we can assume for the next 10 years average earnings of 7 per cent on the depreciation accruals.[8] To compute the profitability for the entire life of the project, then, we would show the derivation thus:

[8] The rate of earnings for the depreciation reserve may vary from practically nothing to the earnings rate for current projects. The earnings rate we want here is the one that can reasonably be assumed will exist over the life of the project we are studying; in the example, for the next ten years. It may be doubtful that over the next decade the funds

TABLE H

Composite Earnings-Yield Profitability

Total Initial Capital Required for Project—$10,000
Estimated Life—10 years
Salvage Value 10 years hence—0

Year	(1) Cash Flow (after tax, before depr.)	(2) Straight-Line Depreciation	(3) Profits (1) — (2)	(4) Earned by* Depr. Reserve	(5) Total Earned by Initial Outlay (3) + (4)	(6) Discount Factor at 28%	(7) Present Worth of Total Earnings at 28% (5) × (6)
1	$8,000	$1,000	$7,000	$ 35	$7,035	.781	$ 5,494
2	4,000	1,000	3,000	105	3,105	.610	1,894
3	2,800	1,000	1,800	175	1,975	.477	942
4	1,800	1,000	800	245	1,045	.373	390
5	1,600	1,000	600	315	915	.291	266
6	1,000	1,000	0	385	385	.227	87
7	900	1,000	—100	455	355	.178	63
8	800	1,000	—200	525	325	.139	45
9	700	1,000	—300	595	295	.108	32
10	600	1,000	—400	665	265	.085	23
A. Total Future Earnings Discounted at 28% (i.e., present worth)							$ 9,236
B. Present Worth of $10,000 10 Years Hence Discounted at 28% (same rate used for Column (6)—i.e., "Redemption Price" in investor's terms)							850
TOTAL (A + B) (Which should equal, or nearly equal, the initial outlay of $10,000)							$10,086

* See Table I

As the investor would look at this computation he would say to himself: "Since the present worth of all future earnings and of the redemption price discounted at 28 per cent equals what I shall have to put into the project, this means that the project will use my $10,000 for ten years, pay me what is equivalent to interest of 28 per cent each year, and repay my original outlay at the end of the 10-year period. If I have faith in the people who made these estimates, that is, if I am satisfied that they have made provision for adequately protecting against the wastage of my capital, and if they have honestly told me the profits that will result, and if I am satisfied with this rate of earnings for the 10-year period, then I am willing to risk my $10,000 on this project."

TABLE I

Derivation of Amounts in Column (4) of Table H

Year	(1) Depreciation Accruals During Year	(2) Average Amount in Depr. Reserve During Year	(3) Earnings of Reserve During Year at 7% (2) × 7%
1	$1,000	$ 500	$ 35
2	1,000	1,500	105
3	1,000	2,500	175
4	1,000	3,500	245
5	1,000	4,500	315
6	1,000	5,500	385
7	1,000	6,500	455
8	1,000	7,500	525
9	1,000	8,500	595
10	1,000	9,500	665

Profit Paid Out Versus Profit Retained. It is the assumption of the earnings-yield method that the investor actually receives the profits from the project each year. In our example we have made the further assumption that the investor takes out, in the form of profits, not only the earnings of the project, but also any earnings from the reinvested depreciation reserve. This further assumption is made merely for the purpose of simplifying the computation.

The profitability method would be simplified even more if we made the assumption that all profits, both from the project and from the depreciation reserve (in other words, the entire cash flow) were retained and reinvested in the business, with no payments at all to the investor until the end of the project's life. At the end of the project's life the investor would receive in one lump sum the entire cash flow compounded at whatever rate the manager determines to be appropriate for funds available internally. Having computed the lump sum amount, it would be a simple matter to determine the compound interest rate that would produce this amount from the capital initially invested in the project over the number of years the project lives.

If this is a realistic assumption, the manager can use this method. In that case the profitability of the project is the compound interest rate so determined and the earnings-yield method need not apply. But in most businesses the investor takes out some of the profits in the form of cash dividends and leaves some of the profits to be reinvested in the business.

Cash Dividends Versus Increased Book Value. The profits from a project to an investor can accrue either in the form of cash return (dividends or interest) or in the greater earnings leverage from the increased value (i.e., book value) of his investment, arising from reinvested earnings of the project. If all funds available internally can be assumed to earn at the same rate as the project, the project's profitability will be the same whether measured by the discounted cash flow method, or the composite earnings-yield method. Furthermore, the profitability will be the same whether it is assumed that the amounts earned by the depreciation reserve are paid out or reinvested, or whether the profits on the project are paid out or reinvested. But where funds available internally have an earnings rate different from

available internally can be invested any more profitably than the total of all funds already invested in the enterprise.

The earning power of all funds can often be approximated by relating net income, after taxes and depreciation but before interest, to the investment in buildings and machinery (gross, before depreciation) plus working capital (i.e., the excess of current assets over current liabilities). The earnings rate so determined will generally be considerably lower than the "return on net worth," and higher than the "return on total assets," but it will represent a reasonable approximation of what any additional funds committed to the enterprise may earn over a period of years. Any modifications necessary to reflect a reasonable outlook for a particular firm should be made. What we want is an estimate for the future; the past can be only a guide.

But the earnings rate so determined cannot be assumed to apply to the future depreciation *accruals* on a given project. It is only the increase in the depreciation *reserve* that is available for earning. Some of the accruals will always be used to cover charges to the reserve. At different times, and in different businesses, the reserve will increase by varying percentages of the accruals, perhaps, from 50 per cent to 80 per cent.

If the return on net worth is expected to run, say 15 per cent, for the next ten years on the average, the earnings rate on all funds invested in the enterprise may run perhaps 10 per cent. This would be a satisfactory assumption to use for the earnings rate for the increase in the depreciation *reserve*. This would equate to perhaps 7 per cent on the depreciation accruals. We have used 7 per cent in the example.

the project being studied, the profitability of the project is affected by the assumption made as to how much of the profits are paid out to the investor and how much are retained in the business.

For instance, the project's profitability indicated in *Table H* is 28 per cent, on the assumption that *all* profits earned by the project and by its associated depreciation reserve are paid out annually to the investor. If we were to make the assumption that some or all of the profits are retained in the business at an earnings rate of only 10 per cent, the profitability to the investor would be reduced below 28 per cent. The reduction would come about because we would, in effect, be forcing him to tie up some or all of his profit money at 10 per cent. The assumption in *Table H* that none of the profits is retained in the business tends to overstate the project's profitability slightly, but the computations are simplified.

SOME MANAGEMENT CONSIDERATIONS

Need for Precision. The profitability of the project in *Table H* was 39 per cent as measured by the discounted cash flow method but only 28 per cent by the composite earnings-yield method. For projects where the profitability is very high, it probably makes little difference what method is used; or even if any method beyond ordinary management "feel" is needed. But where a project's profitability may be approaching a cut-off rate, or the cost of capital or some other yardstick that determines whether a project should or should not be undertaken, then it is highly important to pinpoint the precise rate that applies to the project. For example, if the manager has determined that he should not undertake a project earning less than 20 per cent for the investor, then it is crucial to know whether the project's profitability is, for example, 24 per cent or 17 per cent.

The objection may well be made that such precision is not needed, and that it is illogical because of the impossibility of making estimates with any real accuracy for future periods. It might be argued that this is akin to the engineer who starts with some rough estimates and assumptions and carries his final answer to three decimal places. There is some validity to this objection, and it is not suggested that the composite earnings-yield method be used where less refined methods will suffice. But there are situations in practical business management where refinement and precision are needed in profitability appraisals; where the difference of just a few percentage points may control the manager's decision to go ahead with a project, or to select one project ahead of another.

Partial Life Profitability. With the discounted cash flow method it is not possible to reflect profitability for any time period less than the entire life of a project.[9] This is so because, by the assumptions inherent in the method, the rate of profit remains fixed during each year the project lives, while the principal is being repaid in varying amounts. This is true regardless of the contour of the cash flow. The rate of profit is fixed. The variable factor is the repayment of the principal (comparable to depreciation accruals).

With the composite earnings-yield method, the depreciation contour (i.e., the repayments of the principal) is fixed, and the variable factor is the profits remaining to the investor during each year the project lives. With this method, therefore, it is possible to compute the profitability for the project's first year, or several years, or any portion of its life.

That this may be of real significance hardly deserves mention to practicing managers. It is one thing to say that a project is quite profitable over a long period of time, but it may be equally important to know what those profits will be during the early years. It may not be enough to know that the investor comes out all right in the long run. Sometimes the decision to go ahead with a project may hinge on how big a profit hurdle there is during the years immediately ahead. Often it may be important to know these early year effects, both as to how they will appear on the income statement and in the profitability study.

Questions to be Answered. The manager has every right to have the following information about any project he is considering:

1. *How much initial outlay will be required?*
2. *Where can new capital be obtained, and at what terms?*
3. *What is the profitability of the project:*
   a. *For its entire life?*
   b. *For the first three years (or two or five or whatever period is significant)?*
4. *What will be the effect on the income statement for the project's first year (or each of the first two or three years, or whatever period is significant)?*

The answer to the second question will depend on qualified advice from investment bankers or other financial advisors as to how a new security issue by this firm would be received in the capital market. The answer to the fourth question will usually be available from the work papers used for developing the cash flow for Column (1) of *Table H*. The profitability study, *Table H*, shows the initial outlay (Question 1) and gives the answer to Question 3a. The only remaining unanswered question then is 3b: *What is the profitability of the project for the first three years (or two or five or whatever period is significant)?* Let us use three years as an example.

First Three Years. *Table H* shows the total profits for each of the first three years in Column (5). The earnings-yield method, by trial and error, then develops a discount factor of 47 per cent as measuring the profitability of the project for its first three years, thus:

TABLE J

First Three Years' Profitability

Year	(1) Total Profits (both from project and reserve)	(2) Discount Factor at 47%	(3) Discounted Profits at 47% (1) × (2)
1	$7,035	.680	$4,784
2	3,105	.463	1,438
3	1,975	.315	622
Total discounted profits			$6,844
Discounted value of original outlay three years hence			3,150
Total			$9,994

The profitability rate of 47 per cent for the first three years compares with 28 per cent for its entire life. With a different profit contour we might have arrived at the same 28 per cent profitability over the entire life of the project but a quite different profitability rate for the first three years.

This technique of measuring the profitability of a project for the early part of its life is not suggested as the basis for a decision to abandon the project early in its life. The profitability of 47 per cent for the first three years of the project in *Table J* depends on the project living out its entire life as projected in *Table H*. If early abandonment, with the accompanying tax write-off effects, is a feasible decision, then the profitability of such a revised project should be tested by recasting all the original data to reflect the short life.

REACHING A DECISION

The manager is now in a position to work toward a decision. He knows the project's profitability for its entire life and for the first three years (or whatever period is meaningful to him). He knows how the project will affect the income statement for the first year (or more) of its life. He knows where new capital can be obtained and at what terms.

[9] Of course, a shorter life for the project could be assumed, but then this would require an estimate of the remaining value. This is tantamount to estimating the depreciation contour in using the composite earnings-yield method.

Earnings Requirement for Internal Funds. A portion of the capital needed for new projects in any year will usually be available from two internal sources: (1) The net increase in the depreciation reserve and (2) retained earnings. Obviously retained earnings should earn at least as much for old investors as new capital put into the enterprise by new investors. The question, then, is this: *Should a net increase in the reserve be considered as "free capital" or is there an earnings obligation associated with it?*

Perhaps if the profitability studies of all past projects had anticipated zero earnings on the depreciation reserve there might be some justification for the "free capital" argument. Certainly the depreciation reserve, under theoretical conditions, would represent merely the temporary use of this "free capital," as is the case with any other funds available in various types of reserve accounts. How long the funds represented by a net increase in the depreciation reserve are available depends upon the dissimilarity of the contours of accounting depreciation compared with physical depreciation, obsolescence or other wastage, that is, how much earlier we charge depreciation expense than we use it to retire the asset or a portion thereof.

In most cases the practical manager probably would insist that any funds made available from the depreciation reserve earn just as much as new capital or retained earnings. From the viewpoint of the profitability study, therefore, we might well assume that all the capital needed for a given project is new, external capital. This assumption may represent a slight hedge against unestimated contingencies, but it is not of sizable significance.

Minimum Yardsticks. In comparing the profitability of a project with the cost of new capital, the manager gets into considerations that go far beyond the scope of this discussion. The cost of capital is a complex determination. *Should the cost be for equity or debt capital, or a weighted cost with some of each? Should it be historical cost, current cost or estimated cost during the life of the project?*

Most managers probably have some minimum profitability they are willing to consider for proposed projects. The important thing is to have a statement of the project's profitability that is designed in terms comparable to this yardstick. Both can probably best be expressed as a return on capital in terms the investor might use. The composite earnings-yield method is suggested for this use. The final determination for undertaking a proposed project will involve many other considerations that have to be weighed in the balance. Any profitability method can serve only as a helpful aid in arriving at a management decision that is sound for a particular enterprise.

CONCLUSION

Undertaking a new project is a basic responsibility of management. Even though the project may be undertaken for reasons other than financial, the manager (i.e., the president, general manager, chief administrative officer or whoever holds this responsibility) should know what the financial effects of undertaking the project will be. These effects will always include the reaction on the firm's balance sheet and income statement, but the manager should not always make his decision from this viewpoint alone. He should have some method by which he can appraise the profitability of the project in terms the investor might use. These terms should reflect the "real" effects, that is, the economic realities of undertaking the project as distinguished from the "booked" effect that will appear on the company's financial statements.

In appraising the profitability of a project the manager has the moral responsibility toward the investor for doing two things: Protecting the integrity of the investor's investment and stating the project's profits as honestly and accurately as possible over each of the years the project will live. In order to fulfill this responsibility the manager will have to establish an appropriate depreciation expense contour for the project. This contour usually will be based on the depreciation methods used in the company's official accounting, but not necessarily so. The profitability measurement should use whatever depreciation contour will best meet the dual responsibility the manager has toward the investor. The discounted cash flow method does not usually meet these objectives. The profitability measurement should try to answer the question, *"What will the outlay required for this project earn for the investor over the life of this project?"*

The composite earnings-yield method is suggested for answering this question. This method expresses the profit to the investor, both from the project and from its associated depreciation reserve, that will accrue over the life of the project. It assumes that the annual profits, both from the project and from the funds in the associated depreciation reserve, are paid out annually to the investor. Before the "profits" from the depreciation reserve can be developed, the manager has to determine the earning power of such funds. It is suggested that he use as a guide the firm's record and outlook over several years of earnings on the gross investment in buildings and machinery plus working capital.

In addition to the project's profitability rate for its entire life, as determined by the composite earnings-yield method, the manager will want to know the project's profitability during its early years. He may want this shown by the composite earnings-yield method for the first three years (or some other such period) and as the incremental effect on the company's income statement for the first year (or longer period) of the project's life.

While it can be argued that some proportion of the funds used for new projects is always available from internal sources, the manager may well assume that all the initial capital needed to get a project started, from whatever source, should earn at the rate needed for new, external capital. What minimum yardsticks the manager uses for testing the financial desirability of a project goes beyond the scope of this discussion. But it is suggested that whatever yardsticks he uses, and the profitability measure, both be expressed in similar terms, and that they be in terms the investor might use. The composite earnings-yield method can serve for this purpose, with the full recognition that the final determination may involve many factors other than simple financial profitability.

"To get an over-all picture of our business, I suggest we call in the switchboard operator"

LONG SHOTS & CLOSEUPS WITH THE CONTROLLER CAMERA

Cincinnati, Ohio (TOP BELOW)

Directors of the Cincinnati Control of Controllers Institute met recently with Institute President Roger A. Yoder to discuss local and national activities.

(Seated from left): Institute Director C. Kenneth McCracken, Cincinnati; Institute Director Claude W. Hupp, Louisville; Institute Managing Director Paul Haase, New York; Cincinnati Control Secretary Ronald Jeanmougin and Vice President Charles P. Reynolds; Institute President Yoder, Detroit; Cincinnati Control President Louis T. Huser; and Cincinnati Control Directors Arthur L. Erhmantraut, Dean P. Fite, Ralph W. Miller, J. Paul O'Brien, Walter G. Albrinck, and George L. Schafstall.

(SECOND AND THIRD LEFT)

Hempstead, L.I., N.Y.

Members of the Long Island Control of Controllers Institute observed their fifth anniversary on January 12 at a dinner meeting at the Hempstead Country Club, at which national and local officials of the Institute were honored guests. Those present on that occasion were:

(Standing at the head table left to right) Institute Director L. Keith Goodrich, McGraw Hill Publishing Co.; General Chairman of the Institute's 1960 Eastern Conference H. H. Blevins, Merck & Co., Inc.; New York City Control President Harold R. DeJager, Oxford University Press, Inc.; Institute President Roger A. Yoder, Detroit Steel Corporation; Long Island Control President L. E. Robertson, Sperry Gyroscope Company Division of Sperry Rand Corporation; National Director David F. Devine, American Bosch Arma Corporation; Eastern Area Vice President Donald P. Jones, Sun Oil Company; and Newark Control President Max S. Simpson, Socony Mobil Oil Company.

(LOWER LEFT)

New York, N.Y.

Members of Controllers Institute's Committee on State and Local Taxation met in New York on January 13 to review the status of their recommendations and to plan future steps in connection with the Committee's program. *Seated center at the table* is the Committee's chairman, L. A. Ridgway, comptroller, Associated Seed Growers, Inc., New Haven, Conn. Also present, *seated left to right,* were Harry J. Fravert, Walter Walsh, LaBurne C. Metzger, Walter Chwals, A. H. Wiedeman, Mr. Ridgway, Colin MacLennan, Paul A. Reck, Claude W. Hupp, Alvin F. Lundberg and M. B. Shelly. *Standing, left to right,* T. E. Devine, Frederick F. Schantz, L. C. Waggoner, Institute President, R. A. Yoder, Paul Haase, Frederick C. Sheppard, Walter W. Walsh and John McFarland.

Profile of an Embezzler

More than $1 billion a year is lost to industry through employe frauds, according to J. S. Seidman of Seidman & Seidman, certified public accountants. Mr. Seidman, president of the American Institute of Certified Public Accountants, based his findings on a study of over 500 cases of accountancy fraud.

The average man who commits fraud is about 36 years old, married, earns $7,000 a year, owns a car, participates in social and community work, and drinks very moderately, according to Mr. Seidman. The offender has generally been employed with his company for more than five years and has reached a position of trust by honesty and competent effort. His home may be in any part of town and he may occupy any position from watchman to president.

"Most embezzlements are made possible because employers have faulty systems of control or, if the system is a good one, because of a human slip-up in applying the system," Mr. Seidman said. "In a few instances, the employe has been trained to steal for the employer and winds up stealing from him.

"Generally, what the thief does," Mr. Seidman explains, "is to grab the cash on its way into his company and hope that the money will not be missed for some time. Another channel is to take money out of the company by fake disbursements. A frequent hideout is the petty cash box, or else the padding of bills, payrolls and expenses. Sometimes he is connected with two institutions—his company and a charitable enterprise, for example. He then plays one against the other.

"Investigations and check-ups by auditors do not always uncover frauds because the audits may be too limited in scope or the auditor, who is after all only human, may slip a cog. Generally, however, it will be found that the fraud doer has gotten by because the company has, to save money, gambled on a skimpy control system and has lost. It is like running the risk of going without fire insurance.

"However, when all is said and done, fraud is primarily a matter of human weakness, and the best insurance against it is the proper selection and training of the personnel," Mr. Seidman concluded. "Audits of their past activities and keeping tabs on their current outside doings and mode of living will be very revealing."

Corporate Giving

A total of $2,118,000 has been spent by Bethlehem Steel Company since 1953 in assistance to 67 privately endowed educational institutions. Since last January the company paid a total of $348,000 to 32 educational institutions, four of which received money from the company for the first time.

The basis of the assistance program is to give $4,000 to any private college or university for each of its graduates selected by the company for its graduate training program and who remains with Bethlehem for at least four months. The program attracted 87 such graduates in 1959.

Chicago, Illinois

At a recent meeting of the Chicago Control of Controllers Institute, President Roger A. Yoder congratulated Charles F. Axelson, controller, United Gypsum Company, Chicago, on his appointment as the general chairman of the Institute's 1961 Annual Conference to be sponsored by the Chicago Control (of which Mr. Axelson is immediate past president).

Looking on *(left)* are Raymond H. Giesecke, treasurer, McGraw-Edison Company (current president of the Chicago Control) and *(at extreme right)* Charles Z. Meyer, past president of Controllers Institute (1951-2) and vice president and comptroller of the First National Bank of Chicago.

1960 Southern Conference

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Management Decisions and Taxes
Mark E. Richardson, Partner
Lybrand, Ross Bros. & Montgomery
New York, New York

Management Decisions as Affected by State and Local Taxation
Thomas B. Noble, Treasurer
Stockham Valves & Fittings, Inc.
Birmingham, Alabama

The Controller and Legal Aspects of Corporate Business
Charles Eichenbaum, Sr. Member
Eichenbaum, Scott & Miller
Little Rock, Arkansas

The Controller and Embezzlement
R. L. Ballard, Special Auditor
Liberty Mutual Insurance Co.
Atlanta, Georgia

The Controller Should Meet Today's Challenges
Dudley E. Browne, Vice President-Finance, Lockheed Aircraft Corp.
Burbank, California

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A Mardi Gras Party
Events for the Ladies

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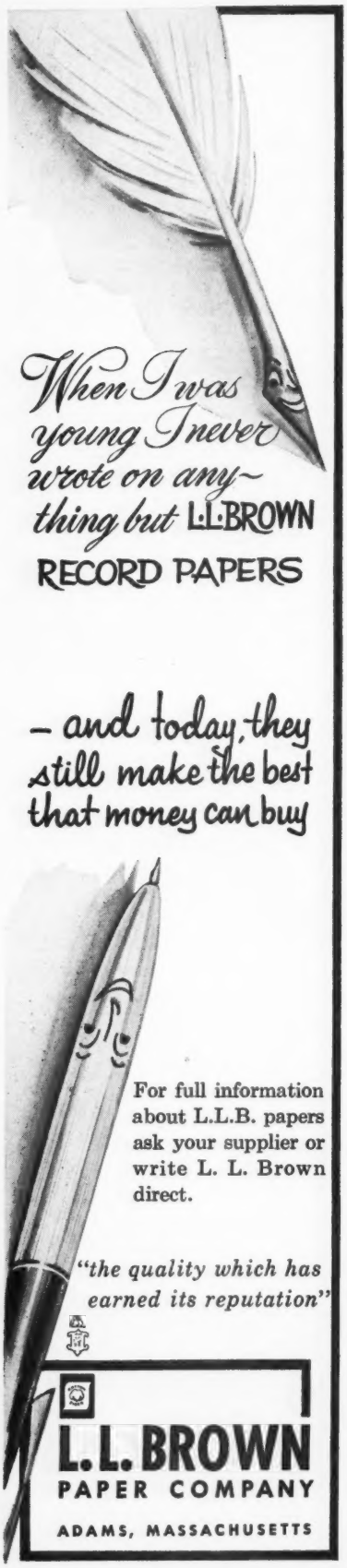
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Research Notes

Capital Expenditures Roundup

Business investment in plant and equipment is continuing its gradual upward trend, according to recent reports by the Government and private agencies. The Department of Commerce and the Securities and Exchange Commission estimated 1959's figure at $32,641,000,000 or 7 per cent greater than 1958's.

McGraw-Hill's survey indicated 1959's increase over '58 as 5.7 per cent and estimated spending in 1960 would be 10 per cent greater than in 1959. This study encompasses more spending than the Government's does, so the two are not directly comparable. McGraw-Hill said part of the 1960 increase derived from slowdowns in 1959, caused partly by the steel strike.

The National Industrial Conference Board put company appropriations for plant and equipment spending in the third quarter of 1959 at $1,786,000,000 (based upon 500 reporting companies)—a 53 per cent increase over the third quarter of 1958. The NICB survey, prepared for *Newsweek*, measures industry's plans after they have become actual money appropriations. The other two surveys measure farther ahead, but on the basis of plans rather than appropriations.

The NICB report attributes 1959's slow growth in appropriation approvals (as compared to 1955) in part to greater excess capacity at the beginning of the present recovery thereby causing a lag in the need for additional productive capacity.

A second and related reason is the technologically oriented nature of the current expansion with investment going into an increasing flow of "small" cost-cutting innovations—a change less likely to lead to bursts of capital expansion than is shortage of productive capacity. Thus, this may be a capital goods expansion of "greater duration, though less hectic, than earlier expansions."

Corporate Financing in '60 to Top '59, Investment Men Say

Corporations will do more financing in 1960 than in 1959 and more of it will be through the sale of common stock, according to a majority opinion of delegates at the 48th annual convention of the Investment Bankers Association of America. Most said capital demands by industry will pick up in 1960 over 1959, assuming that labor troubles in the steel industry are resolved, and that the current high cost of money raised through bonds will induce more corporations to raise their cash requirements by selling stocks.

A goodly minority, however, figure 1960's money-raising corporations will be little changed from 1959 either in volume or the ratio between bond and stock financing. Almost none thought corporate financing in 1960 would be smaller or that less of it would be represented by stocks as opposed to bonds.

Management Attitudes Toward Graduate Business School Training

The hiring of graduate business school trained men has increased in a three-to-two ratio compared with total executive hiring over the past decade, according to a Bruce Payne & Associates survey.

Respondents reported a 64 per cent increase in total number of executives within their companies since 1949 and a 118 per cent increase of executives with graduate business school training.

Among the company presidents answering the survey, only 20 per cent had such training, while the majority of respondents below company officer level were business school graduates.

In rating the importance of this training when hiring new executives, management answers showed the following degrees of importance in relation to the age of the applicant: 20-30 years old—very important; 30-40—added plus; 40-50—rarely considered; and 50 and over—unimportant.

Jobless Pay Extension Made Permanent in Six States

Six states have enacted permanent laws which automatically extend benefits when unemployment reaches certain levels, according to Commerce Clearing House. The automatic extensions become operative, under prescribed conditions in each state, when the number of claimants reaches a stated percentage of the number of persons covered by the state's unemployment compensation law. The percentages, based on formulas which vary in each state, are: Illinois—4.375 per cent; California, Idaho and Connecticut—6 per cent; Vermont—7 per cent; North Carolina—9 per cent.

Although the normal maximum benefit period in all six states is 26 weeks, five of the new laws extend it an additional 13 weeks when the stated levels of unemployment have been reached. In North Carolina, the extension amounts to eight weeks.

Segmental Approach Recommended for R&D Management

A company that seeks to apply "aggregate controls" (evaluating its whole program in one operation) is wasting its time and energies, according to the Amos Tuck School of Business Administration's booklet, *Evaluating Research and Development: The Segmental Approach.* While the best system for planning, evaluating and controlling a research program will vary in detail from company to company, every company needs to take a "segmental approach," says this report. Quantitative measuring devices should be applied only to those segments of a program that can be evaluated quantitatively, with every other segment judged strictly on a qualitative basis.

Trend Toward Coordination of Product Planning at General Management Level

The coordination of new product planning is a marketing function in 43 per cent of the 252 firms surveyed by the American Management Association's Marketing Division. In 41 per cent (102) of the responding firms, this is handled at the general management level and in 11 per cent (27 firms) by the director of research and development or engineering. A growing trend toward placing this responsibility at the general management level was indicated by 61 per cent of the respondents who believed best results can be obtained when product planners report to general management—the president, general manager, or executive vice president.

Industry to Step Up Executive Training

In asking 174 company presidents, "Does management training pay off?", *Dun's Review* found that although some of the executive training programs begun since World War II have soured, most of the company presidents are still solidly sold on management development and generally in favor of expansion of this activity.

Some of the major trends are more, not less, money for executive development; more on-the-job training; a shift of responsibility from staff to line; a broader, yet more discriminating choice of trainees; and fewer lectures and "canned" programs.

Much of U. S. Industrial Machine Approaching Obsolescence

Sixty-two per cent of 240 companies in the metal-working field reported they were operating with some facilities that were 11 to 20 years old, according to an *Iron Age* poll to ascertain the condition of their equipment. Noting that this is way above the depreciation rates now used in Canada, England, Sweden and other foreign countries, the magazine commented that this is "a sure sign of the growing age of the country's industrial plant."

"Sick Pay" Ruling

Sick pay exclusion tax treatment can now be claimed by expectant-mother employes for the period of convalescence following delivery, according to a recent Internal Revenue Service ruling. The seven-day waiting period is waived when the delivery takes place at a hospital but not at home.

Steady Customers

Seven out of ten American families have incomes between $3,000 and $15,000 and constitute the core of the consumer market. These superconsumers spend about 94 per cent of after-tax income and save about 6 per cent, a ratio which has remained unusually stable in good years.

Publicizing Annual Reports

In a legal precedent defining the rights of corporate directors, the Illinois Appellate Court ruled that a company director has the right to have and keep a copy of the company's annual audited financial report.

CHANGING YOUR ADDRESS?

Notice of change of address for THE CONTROLLER should be received in the editorial offices of THE CONTROLLER, Two Park Avenue, New York 16, N. Y., before the first of the month to affect the following month's issue. For instance, if you desire the address changed for your April issue, we should be notified of your new address before March 1. *Be sure to include your postal zone as well as your old and new address.*

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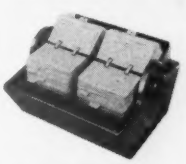

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Personal Notes

MR. HANNA

MR. MOATE

MR. LARSEN

PROMOTIONS . . .

Charles A. Agemian has become controller general of the Chase Manhattan Bank, New York. . . . Stauffer Chemical Company, San Francisco, Calif., has named **Lloyd F. Cummings** assistant vice president-finance. . . . The appointment of **V. Leonard Hanna** as vice president-finance and treasurer of Fenestra Incorporated, Detroit, Mich., was announced recently. . . . **William J. Hogan** is now chairman of the finance committee of American Airlines, New York.

Lester T. Moate was named vice president of American Steel Foundries, Chicago, Ill., and **Russell E. Larsen** became controller of the company. . . . Pennsylvania Power & Light Company, Allentown, Pa., announced recently that **F. H. Markley** has been made vice president-finance. . . . **J. E. Wilson** has become senior vice president of Pittsburgh National Bank, Pittsburgh, Pa. . . . The election of **Arthur J. Sowers** as executive vice president of Univis Lens Company, Dayton, Ohio, was announced recently.

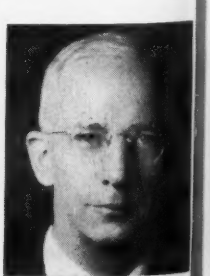
The election of **E. W. Kelley** as treasurer of General Foods Corporation, White Plains, N. Y., occurred recently. . . . **Thomas P. Lynch** has become a partner of Bache & Co., New York. . . . Pullman Incorporated, Chicago, Ill., has elected **Frederick S. Armstrong, Jr.** its comptroller. . . . **H. R. Patton** is now vice president for Business Affairs of Carnegie Institute of Technology, Pittsburgh, Pa. Mr. Patton is a past president of the Pittsburgh Control of Controllers Institute. . . . **John O. Yeasting** has become vice president and general manager of the Transport Division, Boeing Airplane Company, Seattle, Wash. Mr. Yeasting has been active in the affairs of Controllers Institute for many years and is a past president of the Seattle Control; he also served as a director and regional vice president of the Institute.

ADDITIONAL DUTIES . . .

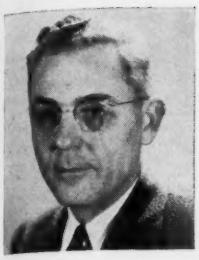
Theodore R. Oakes is now vice president, secretary and treasurer of the Square D Company, Detroit, Mich. . . . **G. L. Sheldon** is vice president and comptroller of the Bank of New York, New York. . . . **Joseph M. Quinn** recently became vice president and treasurer of his com-

MR. SOWERS

MR. KELLEY



MR. PATTON



MR. YEASTING

MR. HOLT

MR. MURRAY

MR. PHELAN

MR. BUJOLD

pany, United States Lines, New York. . . . Federal Reserve Bank of Chicago, Ill., has named **Laurence H. Jones** vice president and cashier.

Willard D. Holt has assumed the responsibilities of vice president and controller of Provident Mutual Life Insurance Co., Philadelphia, Pa. . . . **Stanley B. Murray** has added the duties of vice president to those of controller of the M. J. B. Co., San Francisco, Calif. Mr. Murray is very active in the affairs of Controllers Institute; he is a past president of the San Francisco Control and is currently a director of Region XII of the Institute. Mr. Murray is also General Chairman of the 1960 Annual Conference of Controllers Institute to be held in San Francisco next October.

Kropp Forge Company, Chicago, Ill., has elected **Fred E. Mussman** treasurer and controller of the company. . . . **Horace R. Mustard** was elected vice president-finance and controller of Pittsburgh Coke & Chemical Company, Pittsburgh, Pa. . . . **O. J. Engle** is now vice president and comptroller of Pullman-Standard, a division of Pullman Incorporated, Chicago, Ill. . . . **William R. Phelan,** vice president-treasurer of United States Fidelity & Guaranty Co., Baltimore, Md., was elected secretary-treasurer of Fidelity and Guaranty Life Insurance Company, a newly formed subsidiary. Mr. Phelan is a past president of the Baltimore Control of Controllers Institute.

NEW CONNECTIONS . . .

Vann Meador has joined Davenport Hosiery Mills, Chattanooga, Tenn., as treasurer and assistant secretary, succeeding **Jack Wilkinson** who has retired. Mr. Meador is active in the affairs of Controllers Institute. He is a past president of the Chattanooga Control. . . . **Richard C. Steel** has been appointed vice president in charge of finance of the New York *Herald Tribune*. . . . **Ladd S. Wagner** has become controller of Clinton Engines Corporation, Clinton, Mich. . . . **Francis J. Palamara** was elected comptroller of James Talcott, Inc., New York.

R. K. DiVall is controller of American Hospital Supply Corporation, Evanston, Ill. . . . The election of **Frederick E. Burnham** as vice president-finance of Chance Vought Aircraft, Inc., Dallas, Texas, was announced recently. . . . **Rudolph Epstein** has assumed the responsibilities of vice president and controller of Gruen Industries, Inc., New York.

Frank X. Bujold recently became general manager of Frauenthal Division, Kaydon Engineering Company, Muskegon, Mich. . . . **Dermott Noonan** was appointed treasurer of Federal Paper Board Company, Inc., Bogota, N. J. . . . United States Pool Corporation, Newark, N. J., announced the appointment of **Thomas J. Corbally** as vice president-finance.

San Diego Imperial Corporation, San Diego, Calif., has named **John R. Russell** assistant vice president.

MR. WILKINSON (left) MR. MEADOR (right)

Obituary

DANIEL J. HENNESSY

Second President of Controllers Institute
First President of Controllership Foundation, Inc.

DANIEL J. HENNESSY, 76, second president of Controllers Institute and former president and director of the Jamaica Water Supply Corporation, Jamaica, N. Y., died in Dallas, Texas, on December 23, 1959. Mr. Hennessy retired on December 31, 1958 after serving as president of the utility organization for 13 years.

He was widely known as an expert in utility financial management and for a time in his early career taught and lectured on the economics of public utilities, regulation, valuation, rates, finance and accounting at the University of Pittsburgh. For many years he served on the advisory committee on Industrial Engineering of the School of Industrial Engineering of Columbia University and on its Institute for Research in the Management of Industrial Production. He was a sponsor of the Columbia University Engineering Center.

Born in Ireland, Mr. Hennessy was educated in European classical schools, Brookline (Mass.) High School, Pace College and Alexander Hamilton Institute.

He was associated with Stone & Webster, Inc., for a number of years in capacities of secretary, assistant treasurer and treasurer for various utility subsidiaries in the Southwest and with the Philadelphia Company and subsidiaries at Pittsburgh where he had the administrative direction of finances, taxes and regulatory matters in connection with electric, oil, natural gas, coal, railways and motor coach properties. He was associate controller of the Long Island (New York) Lighting Company and its subsidiaries for a number of years.

Mr. Hennessy, who held membership certificate #50 in Controllers Institute, was national president for the 1933-34 term and also served as the first president of Controllership Foundation, research arm of the Institute, which he helped organize. He was a past president and a director of the Technical Valuation Society of New York and the American Society of Appraisers, and served as economist for gas and electric companies in original cost appraisal and valuation studies.

Personal Notes *(Continued)*

NEW DIRECTORS . . .

The following have been elected to the boards of directors of their companies: **William R. Thomas,** vice president-finance, Cutter Laboratories, Berkeley, Calif.; **Durand B. Blatz,** vice president and treasurer, International Silver Company, Meriden, Conn.; **E. G. Higdon,** vice president and comptroller, The Maytag Company, Newton, Iowa.

NEW APPOINTMENTS . . .

Robert A. Miller, vice president and controller of the State Mutual Life Assurance Company of America, Worcester, Mass., has been elected president of the Worcester Taxpayers Association. . . . **Charles W. Tucker,** management consultant, Washington, D. C., has been appointed to the following committees: Management Services by CPAs of the AICPA and Committee on Cooperation with Other Professional Associations of the Federal Government Accountants Association. . . . **Willard E. Roberts,** secretary and treasurer of the Carpenter Steel Co., Reading, Pa., has been appointed to the Pennsylvania Advisory Board of the American Mutual Liability Insurance Co., Hartford, Conn.

Paul A. Kircher, associate professor of accounting, University of California, Los Angeles, Calif., was re-appointed to the editorial advisory board of the AICPA. . . . **Irving D. Dawes,** retired vice president and treasurer, Virginia-Carolina Chemical Corporation, Richmond, Va., is serving as secretary-treasurer of the University of Virginia Graduate Business School, Charlottesville, Va.

T. G. Redman, comptroller, Swift & Company, Chicago, Ill., was elected chairman of the Advisory Council on Federal Reports. Mr. Redman is one of three representatives of Controllers Institute on the Council; also serving are **Lisle W. Adkins,** comptroller, General Dynamics Corporation, New York, and **L. E. Robertson,** assistant treasurer, Sperry Gyroscope Co. Division, Sperry Rand Corporation, Great Neck, N. Y. Other sponsors of the Advisory Council on Federal Reports, which advises the Bureau of the Budget on methods of improving government questionnaires, reporting business procedures and statistical programs, are the American Retail Federation, American Society of Association Executives, Chamber of Commerce of the U. S., and the National Association of Manufacturers.

COMPANY CHANGES . . .

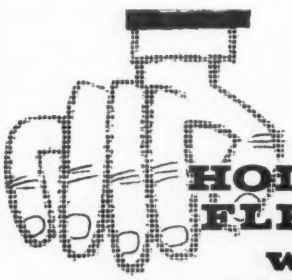
Harry G. Bowles was elected controller of Burroughs Corporation, Detroit, Mich. He had been plant manager of the Mittag Division in Park Ridge, N. J. . . . **Russell M. Braund** has been appointed administrative vice president-accounting of United States Steel Corporation, Pittsburgh, Pa., and James L. Ortner has been appointed vice president-accounting.

SPEAKERS . . .

William G. Hodupp, president, Toledo Home Mortgages, Inc., Toledo, Ohio, was a panelist on "Business Management and Financing" at the Annual Home Builders Convention and Exposition, at Columbus, Ohio.

AUTHORS . . .

Robert B. Curry, vice president and comptroller, Southern Railway System, Washington, D. C., is author of "The Public Administrator as a Professional Manager," published in *Advanced Management,* December 1959. The article is based on an address by Mr. Curry before the Cleveland Chapter of the American Society of Public Administration. . . . **Edward G. Rider,** vice president and comptroller, Citizens National Bank, Los Angeles, Calif., is author of an article in the December issue of *Auditgram* entitled "Planning for Profits." . . . The January 1960 *Journal of Accountancy* carried an article on "The Changing Role of the Controller" by **Douglas L. Hamilton,** controller, Home Electronics Division, Sylvania Electric Products, Inc., Batavia, N. Y. . . . The same issue also had an article on "Improving Auditor-Client Cooperation" by **Ralph E. Wilgus,** treasurer and controller, Rhodes, Inc., Atlanta, Ga.



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No Formula for Reducing Labor Turnover But Helpful Devices Cited

A COMPANY looking for a blueprint to follow in reducing its labor turnover rate is "doomed to disappointment," reports Dr. Frederick J. Gaudet in "Labor Turnover: Calculation and Cost," a new American Management Association study.

Techniques for reducing labor turnover that have been reported as successful in one company almost invariably will be reported as failures in another company, he observes, and the findings of one researcher often will contradict the findings of another.

However, a number of devices have been credited with reducing turnover in a sufficient number of cases to warrant attention. Among them are selection devices such as the weighted application form and psychological testing, on-the-job methods such as better training techniques and more effective communication, and devices aimed at finding out why employes leave the company.

Dr. Gaudet points out that although psychological tests for industrial situations generally have not been constructed to reduce turnover, they apparently have been quite successful when used for this purpose. He reports on a number of studies that have demonstrated the effective use of intelligence tests in reducing turnover.

The effects of good training methods on turnover is seen in the study of a company that had a particularly high turnover rate during employes' first three months on the job. The closer an employe came to reaching the "standard rate" the more likely he was to quit. An analysis of the problem revealed that new employes had no way of knowing how well they were advancing. They were told only that they were expected to reach the standard rate after a certain number of weeks. Setting weekly goals resulted in a turnover drop of more than 50 per cent among these employes.

Another case discussed in the report deals with a turnover problem in one firm resulting from poor downward communication on company policy on merit increases. The problem was solved with the investment of a few hundred dollars in a new pamphlet describing the policy. Discussion of the pamphlet with employes by members of the personnel department paid off in a sharply decreased turnover rate. Dr. Gaudet remarks, "If an incentive program is not understood, it is certainly not working. So, full and complete indoctrination on such company policies is a good preventive measure, particularly where wage incentive plans are at all complicated."

The hard part of attacking the labor turnover problem is finding out why employes leave. The "exit interview" (one that takes place when the employe leaves the company) can be used to obtain this kind of information. It can serve a twofold purpose: to salvage some intended "quits," and to provide information to top management as a basis for corrective action.

The main job of the exit interviewer is to find out the real reason a worker has decided to quit. This means sifting through the reasons given by an employe who may not want to reveal his true reasons or who may not really know what his reasons are. Two hazards of exit interviewing are the human tendency of employes to give socially acceptable answers rather than risk "tattling" or a bad reference, and the lack of skill of many interviewers.

A relatively new technique that has produced significant information about why workers quit is the "post-terminal interview," in which workers who have been separated are asked on a questionnaire to state again their reasons for leaving. A study cited in the report showed that in one company the reasons given for quitting at the time of the exit interview were largely due to external factors—other employment, leaving the state, military service, etc. The post-terminal questionnaire revealed, however, such factors as poor pay, bad supervision, and slow advancement—all of which are "internal" or subject to management control.

The effect of economic conditions on labor turnover cannot be ignored, Dr. Gaudet emphasizes in the report. "Unless we look at economic conditions, or at national or regional changes in rates of labor turnover, we are very likely to ascribe an improvement to the technique or device we introduce, when the improvement actually may be due to lowering of economic conditions. Almost any method introduced to reduce turnover at the beginning of a dip in the business cycle will probably show a lowering of turnover."

Expense Sheets Mostly Unpadded

Most businessmen shun expense-account padding, according to witnesses before the House Ways and Means Committee. While conceding that abuses exist, they contended the great majority of business executives bent so far backward on their expense accounts that they usually wound up with a loss. For this reason, they believed Congress should not impose any additional limitations on income tax deductions of reasonable ordinary and necessary business expense. The Ways and Means Committee heard arguments on business deductions as one phase of a preliminary study of possibilities of a broad income tax reform.

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Issues at the Heart of the 1961 Budget

(Continued from page 71)

term obligations is higher than on longer-term obligation—as it is at present.

The third effect of the 4¼ per cent limitation is that it results in the creation of inflationary pressures. Short-term obligations of the Federal Government are substantially more liquid than long-term obligations which tend to be held for long periods of time. Short-term obligations are more like currency in that they are more easily available to finance demand for goods and services. Thus the greater the amount of government short-term securities outstanding, the greater the pressures for inflation.

In the words of the President's Budget Message:

> To make possible prudent and flexible management of the public debt, to permit sale of a modest amount of intermediate and longer-term bonds when market conditions warrant such action, and to keep the average maturity of the debt from constantly shortening, it is imperative that the Congress immediately act to remove the 42-year-old 4¼ per cent limitation on interest rates on government securities maturing after five years.

Notwithstanding this, the Congress declined to act on a similar proposal of the President last fall.

9. General Government. The not-inconsiderable but still relatively small planned expenditures for general government will also increase in 1961, largely for two reasons.

In the first place, it is planned to spend about $29 million more to strengthen enforcement programs in the Internal Revenue Service, including the addition of enforcement personnel and the initiation of the use of electronic equipment to insure broader checks on the correctness of reported income and other aspects of tax computation. These developments will be welcomed by controllers across the Nation; they are well aware of the problems of tax enforcement and of the need for using the most up-to-date equipment and staff in this undertaking.

Secondly, there will be additional expenditures in 1961 to provide for planning and construction of office space which will insure more economical and efficient operation of many federal agencies.

Of course, in an activity the size of the Federal Government of the United States the demand for additional or better office space is almost insatiable; the problem is to select the most pressing and most promising cases, and satisfy them as promptly as is practicable. It is the responsibility of the General Services Administration to do that.

The issues here seem relatively small, but they reflect the fact that *central government,* for better or for worse, *is growing* and *that is an issue of major consequence to us all.*

SUMMARY

The issues which are raised in the budget for 1961—and the ones mentioned here are only some of them—are all matters which affect everyone of us as members of the American electorate.

The consequences of the decisions which are or are not made with respect to each of them will affect some of us now and all of us—or our successors—later on.

We will not say that the immediate budgetary consequences of decisions made with respect to these issues transcend in importance all other considerations in the scale of values; it does seem apparent, however, that for many years the importance of fiscal integrity in federal affairs was rated rather low, and the resulting federal debt and its inflationary influence are beginning to be seen as forces to be given adequate recognition in the scheme of things.

And "adequate recognition" means, in times like these, substantial payments toward reduction of the federal debt, and deferral of both tax reduction and the wholesale starting of new programs involving further spending. Financially oriented people accept these as wholly reasonable goals of national policy.

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